FOR DEPARTMENTAL USE ONLY

TECHNIQUES OF INVESTIGATION FOR ASSESSMENT

Vol 7

TECHNIQUES OF INVESTIGATION FOR ASSESSMENT

Vol 7

TECHNIQUES OF INVESTIGATION FOR ASSESSMENT

Vol 7

First Impression: June 2020

Techniques of Investigation for Assessment

Vol. 7

© Income-tax Department, New Delhi

No part of this publication may be reproduced or transmitted in any form by any means, electronic or mechanical, including photocopy, recording, or any information storage and retrieval system, without permission in writing from the copyright owners.

DISCLAIMER

Publishers, editors and authors have taken due care to maintain accuracy and authenticity of content. Errors, if any, are purely unintentional and readers are requested to communicate such errors to the editors or publishers to avoid discrepancies in future.

DIRECTORATE OF INCOME-TAX (PR, P&P)
6th Floor, Mayur Bhawan, Connaught Circus
New Delhi–110001
Ph: 011-23414641, 23411267
E-mail: delhi.ddit.pp@incometax.gov.in

www.incometaxindia.gov.in

https://twitter.com/IncomeTaxIndia

https://www.facebook.com/incometaxindiaofficial

IncomeTaxIndia.Official YouTube Income Tax India

Designed, Typeset and Printed by
Excel Printing Universe, New Delhi–110 067
E-mail: printing@groupexcelindia.com

सत्यमेव जयते

P.C. MODY
Chairman, CBDT &
Special Secretary to the Government of India

भारत सरकार
Government of India
वित्त मंत्रालय/ राजस्व विभाग
Ministry of Finance/ Department of Revenue
केन्द्रीय प्रत्यक्ष कर बोर्ड
Central Board of Direct Taxes
नार्थ ब्लॉक, नई दिल्ली – 110001
North Block, New Delhi – 110001
E-mail: chairmancbdt@nic.in
Tel: 23092648 & Telefax: 23092544

Foreword

A well-functioning revenue system is a necessary condition for strong, sustained and inclusive economic development. Investigation of financial statements is a necessity for an efficent and robust tax adminstration. Investigation involves inquiry into facts behind the books and accounts, into the technical, financial and the economic position of the business or organisation. For a business organisation, investigation implies that an organised, detailed and critical examination of the books of accounts and transaction records (both past and present) of an entity, conducted for a specific purpose or to reveal a truth or to establish a fact with the help of evidence. In general, an effort made to find out the facts, behind a particular situation, to discover the truth is known as Investigation. In recent years the tax administrators are facing the challenge of twin phenomena of globalization and technological advancement which are eroding tax bases. Therefore, it is crucial for tax authorities to cope up with these new tax revenue challenges effectively. By diminishing the importance of national borders, globalization has created new multinational, tax-jurisdictional gray areas that make it easier for taxpayers to avoid or evade taxes.

The ten chapters in this Volume 7 of the Manual will give the Tax Administrators a valuable insights on Indigenous Banking, Banking and Financial Institutions, Chit Funds, Foreign Exchange Dealers, Leasing Companies, Non-Banking Financial Companies, Taxation of Non-Residents & Issues of Taxation in case of Foreign Companies, Business Re-Organization (Mergers, Acquisitions and Demergers), Export & Import Business and Capital Market. These chapters will provide tax authorities guidelines for coping with globalization and technological advancements. As a result of reading this manual, the tax authorities will have a better understanding of the financial statements of an individual or company. They will be in a better position to make informed decisions and to uncover the tax evasion. I would like to place on record my special appreciation for the efforts of all the members of the Committee and other officers associated with the mammoth task of rewriting this Manual. I am confident that this Manual will act as a useful reference point for the officers of the department, while conducting indepth investigations.

New Delhi
Date: 26/06/2020

P.C. Mody
Chairman and Member (Investigation)(A/C)
Central Board of Direct Taxes

Preface

Long ago Heraclitus, a Greek philosopher had declared,

"The only constant is change".

Perhaps, requirement of change was the basic propellant which led CBDT to constitute a committee on 27/11/2017, for reviewing and updating its 15 year old publication on "Techniques of Investigation Manual" (Vol. I to V) 2002. The committee decided to bring the manual in seven volumes. It is indeed a moment of great pleasure for the committee to bring out the Seventh and final volume of the Manual which contains valuable insights on Indigenous Banking, Banking and Financial Institutions, Chit Funds, Foreign Exchange Dealers, Leasing Companies, Non-Banking Financial Companies, Taxation of Non-Residents & Issues of Taxation in case of Foreign Companies, Business Re-Organization (Mergers, Acquisitions and Demergers), Export & Import Business and Capital Market.

Most taxpayers voluntarily comply with their tax obligations. However, some taxpayers persevere in being non-compliant and use any means to evade their tax obligations. It is in respect of those taxpayers, for whom support and monitoring does not improve compliance, that the role of investigation of financial accounting plays an important role.

An effective strategy for learning any new skill is to define it and break it down into logical steps, establishing a progression that can be followed and repeated to reach the desired results. The process of investigation is no exception and can be effectively explained and learned in this manner.Any investigation function is a tool for collecting facts. Investigative tasks relate to identifying issues, gathering information, collection and collation of evidence, examination of witnesses, etc. These are essential tasks that must be learned and practiced to attain a high degree of skill into the investigative thinking process. The investigative process is a progression of activities or steps moving from evidence gathering tasks, to information analysis, to theory development and validation, to forming reasonable ground of belief, and finally to the determination of real income.

With the advancement in technology, new ways and means are increasingly being adopted by the tax payers for effecting tax evasion and tax frauds. It is said: Financial investigations are usually very document intensive as it involve records which point to the movement of money, i.e., the money trail. Any record that pertains to or shows the paper trail of events involving money is important. The major goal in a financial investigation is to identify and document the movement of money. The link between where the money comes from, who gets it, when it is received and where it is stored or deposited, can provide proof of tax evasion.

Tax evasion, public corruption, bank frauds, terrorist financing, etc. are just a few examples that revolve around money. In these cases, the financial flow investigation are the key factors. Traditional tax investigation techniques have limitations as the tax evaders are adopting sophisticated financial tools using latest technology to evade the taxes. Financial statement fraud surfaces in many different forms, although once deceptive accounting practices are initiated, various systems of manipulation

are utilised to maintain the appearance of sustainability. Common approaches to artificially improving the appearance of the financials include: overstating revenues by recording future expected sales, understating expenses through such means as capitalizing operating expenses, inflating assets' net worth, hiding obligations off of the company's *balance sheet* and incorrect disclosure of related-party transactions and structured finance deals, etc.

Since financial crimes are global, borderless, and prolific, we must expand and enhance our overall effectiveness in combatting international tax evasion, money laundering, and other financial crimes for which we have purview by utilizing all available resources, techniques, and networks. We are in an era of global financial transparency, where countries are advocating for increased exchange information with foreign counterparts, and pursuing rigorously revenue lost through tax evasion. With an increasingly globalized economy and technological advancements, we are witnessing trans-national organized tax evaders groups and other perpetrators who abuse the vulnerabilities in our financial systems. These frailties can have a significant and devastating impact both on national revenues and security. The Income Tax Department with our unique forensic accounting skill sets is well positioned to combat these national security threats and pursue illicit financial flows that were either derived from tax evasion, international tax schemes, cybercrime, or terrorist financing.

Thus, as a tax administrator it becomes exceedingly important to constantly upgrade and update ourselves with the new changes in the Law, to counter resourceful opponents. Keeping this daunting task in mind, committee has come up with the current revised Manual. This edition represents an extensive revision of the chapters in the first edition and a substantial enlargement through the addition of new chapters. During revision, efforts have been made to delve upon minute details of modern ways of tax evasion, amendments in statute, latest case laws defining current position of law, case studies, ways of exhaustive verification etc. for honing the investigative skills of the officers. It is expected that the new skill sets discussed in this manual will add to the armour of the officers to enable them to combat more efficiently with the sophisticated ways of modern tax evasion. The ten chapters on various trades and services in this manual will arm and equip tax administrations and investigators with the best practices to promote efficient systems for fighting tax crimes for years to come.

The Committee acknowledges the effort of all the officers who have contributed material and made value addition for compilation of this Volume. We are also grateful to the Editorial Board for going painstakingly through the write-ups and for their valuable inputs.

Ajai Das Mehrotra
Chairman of the Committee

Acknowledgments

CONTRIBUTORS TO VOLUME 7

Shri K.K. Vyawahare	Director General of Income Tax (Inv.), Mumbai
Ms. Chaitali Panmei	Pr. Commissioner of Income Tax, Mumbai
Shri D.C. Patwari	Pr. Commissioner of Income Tax, Mumbai
Shri Pravin Kumar	Pr. Director of Income Tax (Inv.), Kolkata
Shri R.S.V.S. Pavan Kumar	Pr. Commissioner of Income Tax, Mumbai
Shri Anil Kumar	Pr. Commissioner of Income Tax, Mumbai
Shri C.S. Gulati	Commissioner of Income Tax, Mumbai
Shri L.K.S. Dehiya	Commissioner of Income Tax, Mumbai
Shri Sanjay Singh	Commissioner of Income Tax, Mumbai
Shri Shahi Sanjay Kumar	Commissioner of Income Tax, Mumbai
Shri Sunil Kumar Jha	Commissioner of Income Tax, Mumbai
Shri V.K. Gupta	Commissioner of Income Tax, Mumbai
Shri V. Palanivel Rajan	Commissioner of Income Tax, Chennai
Shri Ashim Kumar Modi	Addl. Commissioner of Income Tax, Mumbai
Shri Manoj Kumar Mahar	Addl. Commissioner of Income Tax, New Delhi
Shri Aarsi Prasad	Addl. Commissioner of Income Tax, Mumbai
Shri A.H. Choudhury	Addl. Director of Income Tax (Inv.), Kolkata
Shri B. Jaya Raghavan	Addl. Director of Income Tax (Inv.), Chennai
Shri Harshad Aradhi	Addl. Commissioner of Income Tax, Mumbai
Shri Javed Akhtar	Addl. Commissioner of Income Tax, Mumbai
Shri Malikarjun Utture	Addl. Commissioner of Income Tax, Mumbai
Shri Murli Mohan	Addl. Commissioner of Income Tax, Chennai
Shri Naveen Gupta	Addl. Commissioner of Income Tax, Mumbai
Dr. Pramod Nikhalje	Addl. Commissioner of Income Tax, Mumbai
Shri Sridhar Kr. Bhattacharya	Addl. Director of Income Tax (Inv.), Kolkata
Shri Pushpendra Singh Choudhary	Addl. Commissioner of Income Tax, Surat
Shri Ankush Kapoor	Jt. Commissioner of Income Tax, Mumbai
Shri Basavaraj Hiremath	Jt. Commissioner of Income Tax, Mumbai

Shri Ben Mathew Verkey	Jt. Director of Income Tax (Inv.), Chennai
Shri Mudit Srivastava	Jt. Commissioner of Income Tax, DTRTI, Mumbai
Dr. Shanteshwar Swami	Jt. Commissioner of Income Tax, Mumbai
Shri S. Tamil Selvam	Jt. Director of Income Tax (Inv.), Chennai
Ms. Aastha Madhur	Dy. Commissioner of Income Tax, Mumbai
Ms. A. Alankrutha	Dy. Commissioner of Income Tax, Mumbai
Shri Ashish Kumar Shukla	Dy. Commissioner of Income Tax, Mumbai
Shri Harshad Parghi	Dy. Commissioner of Income Tax, Mumbai
Shri J.V. Menon	Dy. Commissioner of Income Tax, Mumbai
Shri Sanjay Jha	Dy. Commissioner of Income Tax, Kolkata
Shri Shubham Agrawal	Dy. Commissioner of Income Tax, Mumbai
Ms. Sujata Verma	Dy. Commissioner of Income Tax, Mumbai

Committee for Review and Updating of Manual

of

Techniques of Investigation for Assessment

Sl. No.	Name	Designation	Station	Position
1	**Shri Vinodanand Jha**	Chief CIT (Since Retired)	Mumbai	Chairman
2	**Shri N.P. Sinha**	Chief CIT (Since Retired)	Mumbai	Chairman
3	**Shri A.D. Mehrotra**	Pr. Chief Commissioner of IT	Ahmedabad	Chairman
4	**Shri K.K. Vyawahare**	DGIT(Inv.) (Since Retired)	Mumbai	Member
5	**Shri Harish Kumar**	DGIT (Inv.)	New Delhi	Member
6	**Shri Nilimesh Baruah**	Chief CIT (Since Retired)	New Delhi	Member
7	**Shri Pravin Kumar**	Pr. DIT (Inv.)	Hyderabad	Member
8	**Shri Alok Johri**	Pr. DIT (Inv.)	Raipur	Member
9	**Shri Yogendra Choudhary**	PCIT	Mumbai	Member Secretary
10	**Shri Sunil Kumar Singh**	CIT (Inv.)	CBDT	Member

Editorial Board for Volume 7

Shri Ajai Das Mehrotra
Pr. CCIT, Gujarat
Ahmedabad

Shri N.P. Sinha
CCIT(C)-2, Mumbai
(Member, AAR, New Delhi)

Dr. Rananjay Singh
CCIT, Vadodara

Shri Prasenjit Singh
CIT(TDS), Vadodara

Shri Manoj Kumar Mahar
Addl. CIT, New Delhi

Shri Pushpendra Singh Choudhary
Addl.CIT, Surat

C O N T E N T S

❖ Foreword v

❖ Preface vii

❖ Acknowledgments ix

❖ Committee xi

❖ Editorial Board xiii

1. Indigenous Banking 1

2. Banking and Financial Institutions 11

3. Chit Funds 65

4. Foreign Exchange Dealers 99

5. Leasing Companies 111

6. Non-Banking Financial Companies 129

7. Taxation of Non-Residents & Issues of Taxation in Case of Foreign Companies 157

8. Business Re-organisation (Mergers, Acquisitions and Demergers) 191

9. Export & Import Business 221

10. Capital Market 239

Index 279

CHAPTER

1

Indigenous Banking

1. INTRODUCTION

1.1 The system of indigenous banking in India dates back to ancient times. Money-lending operation in India was found in the Vedic period i.e. 2000 to 1400 B.C. and money-lending was considered to be an extremely important activity and next to till age, harvesting and trading, money-lending was amongst the most important professions. In the Buddhist period, ample evidence of the existence of Sresthis or Bankers has been obtained. They were mainly engaged in lending money to traders, to merchant adventurers for going to foreign countries, to explorers to extract valuable materials from forests and to kings for meeting financial difficulties due to war or other reasons against the pledge of movable or immovable property or personal surety. The indigenous bankers played a major part in lending money, financing internal and foreign trade and giving financial assistance to rulers during periods of stress. From the ancient period and until the middle of the nineteenth century, the indigenous financial agencies constituted the bulk of the Indian financial system. In fact, they not only provided credit to traders and producers but also to the governments of those days.

1.2 The advent of the British had an adverse impact on their business and thereafter, with the growth of commercial and co-operative banking geographically as well as functionally, especially since the mid 1950s, the area of operations of these agencies has contracted further. With the gradual enhancement of the regulatory control by the Central Bank, i.e., Reserve Bank of India, the State Governments and other agencies of the Government, the functions as well as area of the indigenous form of banking has significantly declined over the years. However, they still play a significant role in rural & semi-urban areas. In fact, as per the All-India Debt and Investment Survey as on June 30, 2012 (NSS Fifty-Nineth Round released in November 2016) had shown

that the share of Professional moneylenders in the total dues of rural households is 28.2 per cent and if agricultural moneylenders are also included, the share of moneylenders becomes 33.2 Per cent of the total. It indicates the importance of the moneylenders in the rural areas of banking.

1.3 Indigenous financial agencies in the Indian money market can be broadly classified into two categories, i.e. Bankers, and Money lenders. While bankers perform certain acts of banking and act as financial intermediaries who while lending to others also avail of bank credit and accept deposits from others, moneylenders use their own funds for lending purposes. Since the bankers used to accept funds from other depositors also including public deposits and also availed bank credits, it had access to quite large funds compared to the moneylender and its functions were more organized and methodical. At the same time, these bankers had quite an informal approach to banking with easy access to customers with flexibility in their functioning making them attractive to those who find it difficult to get access to the formal banking system due to its rigid and inflexible rules and regulations.

2. The indigenous bankers were normally family firms, who continue to operate as traditional-style bankers and many of these firms have continued in this business for several hundred years. These bankers besides being hereditary, are confined to a few castes and communities. The can be mainly categorized as under:

a. **Gujarati Shroffs:** They are an organised class of shroffs and some of them perform functions akin to a commercial bank. They also used to receive deposits on current and fixed accounts from the public. They advance money on call and fixed periods on security or on personal credit, arrange remittance of funds by issuing hundis for private and commercial purposes like banks. Some of them combine banking with commission agency or trade in cloth, grains, and other commodities and their banking operations are more or less ancillary to their trade. However, with restrictions from the RBI on receipt of public deposits, their access to funds and thereby the size of their operations has substantially declined.

b. **Multani or Shikarpuri Shroffs:** These are called Shikarpuri as their head quarters used to be in Shikarpur of Sindh (now in Pakistan). Functionally, what distinguishes Shikarpuri financiers from Gujarati shroffs is their major reliance on their owned funds and borrowings from commercial banks rather than deposits from the public as the source of their funds. The Shikarpuri traditionally used to lend mainly by discounting 'Multani hundis', which are 90-day term notes. In the past they used to borrow from commercial banks by getting these hundis rediscounted but with the decline of rediscount facilities with banks, their access to the capital has declined resulting into decrease in business. Now their business has have moved towards lending against demand promissory notes and giving instalment credit.

c. **Nattukottai Chettiars and Kallidai Kurichy Brahmins of the South India:** They were mainly using their own funds or loans from friends and relatives and were mainly dealing in hundis and in moneylending.

d. **Mahajans or Marwari Indigenous Bankers:** These moneylenders mostly operate in North India and some areas of East and South. These Mahajans also use market loans besides their own funds and they are mainly engaged in moneylending business though some are also engaged in transfer of funds for trading in remote areas by endorsing cheques/ drafts and hundis received by them in favour of parties intending to remit funds.

2.1 The various instruments/ documents used for conducting the trade:

i. **Hundi:** It is a financial instrument that developed in Medieval India for use in trade and credit transactions. Hundis are used as a form of remittance instrument to transfer money from place to place, as a form of credit instrument or IOU to borrow money and as a bill of exchange in trade transactions. The Reserve Bank of India describes the Hundi as "an unconditional order in writing made by a person directing another to pay a certain sum of money to a person named in the order."

The hundis can be broadly classified as under:

a. **Darshani** hundis (sight or demand hundis): This is a hundi payable on sight. It must be presented for payment within a reasonable time after its receipt by the holder. Thus, it is similar to a demand bill.

b. **Muddati Hundis:** A muddati or miadi hundi is payable after a specified period of time. This is similar to a time bill.

Darshani hundis are of different varieties, some of which are as under:

1. **Shahjog Hundi:** This is drawn by one merchant on another, asking the latter to pay the amount to a third merchant. It is generally a Darshani and can be transferred freely from one person to another by mere delivery but it is not payable to bearer. In some respects it is similar to a crossed cheque.

2. **Namjog Hundi:** It is a hundi payable to the party named in the hundi or his order. Such a hundi is similar to a bill on which a restrictive endorsement has been made.

3. **Dhanijog Hundi:** 'Dhani' in vernacular language means owner. Thus, a dhanijog hundi is one which is made payable to the owner, or a holder or bearer-owner. It is just like a bearer cheque and the holder of it becomes holder in due course if he takes it bona fide and for value.

4. **Jokhmi Hundi:** The term 'Jokhmi' has been derived from the Hindi word 'jokhim' meaning 'risk'. Such a hundi is conditional in the sense that the drawer promises to pay the amount of the hundi only on the satisfaction of a certain condition generally the safe arrival of goods of trade. It is a combination of bill of exchange and insurance policy and payable only when the goods arrive in safe and sound condition.

5. **Jawabee Hundi:** A hundi, which is in the form of letter or recommendation to a banker for payment of a certain sum of money to a specified person, is termed as jawabi hundi.

6. **Firmanjog Hundi:** The term Firman refers to order in vernacular language

and therefore, a firmanjog hundi is made payable to the order of payee. It is just opposite of dhanijog hundi which is payable to the bearer only.

ii. **Promissory Notes:** A popular method of advancing money is against a written promissory note. This is a legal document and conforms in all respects to the character of the same as laid down in Section 4 of the Negotiable Instruments Act where the promissory note has been defined as "An instrument in writing containing an unconditional undertaking signed by the maker to pay a certain sum of money to or to the order of a certain person or to bearer of the instrument." It has to have following requisites:

   a. The documents must contain an unconditional undertaking to pay.
   b. Undertaking must be to pay only.
   c. The money to be paid must be specified.
   d. Document should be signed by the maker.
   e. A promissory note may be payable on demand or after certain period.

The distinction between a hundi and a promissory note (pronote) is as under:

1. Whereas in a promissory note, amount specified is shown as payable on demand, the amount noted in a hundi is payable after the lapse of a specified period which is expressed in days. As such a hundi can be discounted whereas a promissory note cannot be discounted either with a third party or bank.
2. A person advancing money on promissory notes cannot advance funds in excess of his own and/ or borrowed capital, whereas a person advancing money on hundis may in addition to his own as well as borrowed funds utilise the funds by discounting hundis with banks or 3rd parties.
3. Whereas a promissory note may be executed on a plain sheets of paper with the requisite stamps affixed thereon; a Hundi Khoka is to be purchased from the stamp-vendor and is available with him in different denominations.

iii. **Dastavez or Bonds:** Sometimes bonds are used instead of promissory notes which are made on stamped legal forms and are duly executed. They contain all the terms and conditions of the advance agreed upon such as the rate of interest, penalty or default etc.

iv. **Mortgage:** Money lenders advance the money on the security of property upto a part of the market value of the land. Usually there are two types of mortgages.

   a. **Ordinary Mortgage:** Where property is mortgaged but ownership of the land remains with the borrower. There is normally a provision that in the event of the borrower failing to meet the loan liability, lender can take possession of the property. In the case of simple mortgage of land, ordinarily no period is specified and mortgage is allowed to run the whole course.
   b. **Usufructuary Mortgage:** In this the borrower makes over a part of the property which is occupied

by the creditor who receives the income therefrom as interest, with an underlying condition that on repayment of the principal, the borrower will get back his property.

v. **Market-Loans:** This system is followed to finance small traders, vendors, taxi or auto-rickshaw drivers. Normally money is expected to be returned on instalment basis, which may be on daily basis or weekly or monthly basis. These moneylenders or indigenous bankers employ some managers or munims to ensure collection on day to day or week to week basis.

3. AREAS OF TAX EVASION

i. The amounts lent may not be recorded at all in the books of account resulting in consequent nondisclosure of interest income.

ii. There may be an understatement of interest receipt though transaction is recorded in the books of account.

iii. Concealed income may be introduced in the guise of amounts borrowed from other persons.

iv. Other persons may be assisted to deposit their money in benami names in his books of account.

v. Some clients may be accommodated to utilise/ borrow money not in their own names but in benami names and thus not account for the transactions in their books of account at all though services rendered may be recompensed besides the interest at normal rates.

4. AREAS OF INVESTIGATION BY THE DEPARTMENT

4.1.1 The banker may not have accounted for the interest earned or shown lesser income. This unaccounted income is generally introduced by the banker in its books through deposits from others or in the capital account. The principal source of income of any banker is the return on capital employed and loaned out. Now, after restrictions from RBI on these bankers from accepting public deposits and also liability of tax from gifts from non-relatives under the Income-tax Act, the deposits are mostly shown to be received from relatives (mostly ladies) and creating a facade of genuineness to these deposits by filing returns in the names of such persons. Therefore, proper, intelligent and sustained cross-examination and enquiry needs to be conducted to ascertain the identity of these alleged depositors who may either turn out to be non-existent or found to be of no means at all.

4.1.2 Credit accounts in the banker's books which show no change for number of years except for credit of interest may also call for special scrutiny to ascertain their genuineness. Where such temporary accommodations show large number of transactions with other bankers copies of their current account should invariably be cross-verified, and if necessary their statements should be recorded and books carefully scrutinised by issue of summons under Section 131 of Income-tax Act.

4.1.3 If the ledger produced by the banker shows closed accounts without there being any interest charged or paid it may represent an advance made by the banker and returned by the debtor where the interest receipt is omitted by the banker.

4.2.1 The other aspect of the investigation is to ask for the types of operations the banker deals in. In most cases the principal operation is lending against hundis. These bankers prefer to advance against hundis as these are short-term advances, which are tailor-made for increasing the turnover of their capital.

4.2.2 For examining the same, the Assessing Officer should obtain a cash-flow statement so as to examine the borrowings from commercial banks and other sources. While dealing with the borrowings and discounting facilities from commercial banks, the Assessing Officer should obtain the names & addresses of all such banks & make reference to them for details of credit limits sanctioned to the assessee. It has been observed that a large number of hundis and pronotes have been seized with the names of the banker and dates etc. are not filled in. Also, discharged hundis in the premises of the lenders were found whereas such discharged documents are expected to be in possession of borrower since these are the only proof for the borrower of having discharged the loan. Also signed blank cheques issued by the borrower were found though the hundis are discounted with banks.

4.3 Further, benami business is quite rampant in this class of business. To divert the income, lending concerns are started in the names of spouses, sons, brothers etc. The usual methods of investigating benami businesses should be employed while dealing with the cases of such class of business also.

4.4 The main income of an indigenous banker is from interest on his lending. Therefore, the next step is to determine the interest on the return on loan that is to be subjected to taxation. The ratio of this interest to the principal advanced is the rate per cent at which the money has been advanced. One check that is to be exercised by an Assessing Officer is to find out the effective rate of interest and compare the total interest amount with the total or average amount of advances outstanding during the year or average of the monthly outstanding in the accounting year, which would to a large extent cover variations in a particular year.

4.5.1 Another area of investigation is regarding Bogus hundi loans. In such sham transactions money does not actually pass and the ostensible borrower introduces his own money as loan received from the Hundi banker. It is pertinent to mention that by adopting this method of introducing secreted profits, businessman is not only able to introduce his own funds but is also able to get deduction of interest shown as having been paid to the lender though it is withdrawn by him.

4.5.2 The modus operandi is that when a businessman wants to introduce a sum of money in his books, he approaches a hundi broker, who charges his commission and arranges a hundi loan from an alleged lender. But no money passes as the businessman introduces his own money as loan received from the alleged lender. A hundi is executed by the borrower in favour of the lender, but the lender returns it to the borrower duly discharged without mentioning the date. The date of discharge is put by borrower on the expiry of the period, when he makes an entry of repayment in his books. The banker, for the cooperation extended by him gets an agreed commission in the shape of interest paid to him for the alleged borrowing. To make it look like a bona fide transaction, the beneficiary businessman may also persuade the banker to provide him a cheque for the amount allegedly received from the banker. This is done easily by the businessman passing the money to the banker and the banker in turn depositing the

same in his bank account and issuing a cheque for an equal amount to the businessman.

4.5.3 Another method adopted for perfecting the system of accommodation is by discounting the hundis. The alleged lenders would show that the hundis have been discounted with banks or purjawalas. There are professional persons who purchase or discount hundis with no financial resources. The professional would lend his name for advancing money to the banker. For a nominal consideration, he would sign a small piece of paper, known as 'purja' the Hundi banker would then insert entries above the signatures to show that the hundi has been discounted with the person who has put his signature and on the due date the money has been paid off to that person.

4.5.4 Another method for perfecting the system of accommodation is to arrange for back-dated-entries. The racketeers give hundi for any year as some of the hundi brokers usually keep with them ready stock of old hundi papers. These are executed giving relevant dates.

4.5.5 To start with, the Assessing Officer must ascertain the names of the hundi bankers involved in the case. These can be ascertained from the Balance Sheet as well as from the list giving details of interest paid as the names of persons whose loans were repaid during the course of the year will not appear in the Balance Sheet. Antecedents of such bankers should be checked and information collected, regarding the discounting facilities enjoyed by them with the commercial banks. Where bank accounts are found to be maintained by such lenders, a thorough probe be made in case the alleged lender and the assessee are found to be residing at different places or substantial sums are received from such lenders in cash.

4.5.6 The Assessing Officer should also call for all the discharged hundis and examine them critically. He should particularly note the date of purchase of the hundi paper as well as the date of hundi loan. He may also examine whether it bears a serial number and is properly stamped or not. Duration of the hundi should also be seen, as in the case of genuine hundi loans duration is only 3 months. The names of the person who purchased the hundi-paper may also be verified, as the paper is purchased by the hundi broker who arranges the loan.

4.5.7 Another check point for the Assessing Officers is the noting of the date of maturity of the hundi loan. In case of non-genuine loans, the banker may have to pass several antedated entries for accommodation of various persons. Proper scrutiny in such cases can lead to detection of interpolation of entries which may be in various forms such as noting in different inks, different handwritings etc. Such interpolations are likely to occur in the cash book towards the end of the day.

4.6.1 The most widespread practice used for remitting unaccounted funds and for making 'on money' payments in respect of recorded transactions is through discounting.

4.6.2 The starting point is a transaction for which payment is to made from the unaccounted money from a distant place. Drafts are purchased in fictitious names and these drafts are made payable at the place where payments are to be made. Normally, the bank at such a place insists on the payee being identified before the payment is made. To obviate such a situation, services of an indigenous banker engaged in the business of discounting drafts are utilised. The banker encashes the drafts from the banks and finally pays the broker or the benami of the real

beneficiaries. They receive a commission for the services rendered. It is often by interposing the bankers who have regular discounting facilities with the banks, holders of black money have not only been able to transmit the money easily but also render the detection of such transactions very difficult.

4.6.3 The Assessing Officer should try to locate all the bank accounts of the banker/ discounting firms and ascertain details of the drafts deposited. If from the bank accounts it is found that a large number of drafts have been deposited closely followed by cash withdrawals, he should scrutinize the case in depth. In such an eventuality the Assessing Officer should ask the bank/ assessee to furnish full particulars of the persons who have got the drafts discounted through him, and complete particulars of the persons to whom cash was paid. These details must then be cross-verified with reference to the books of accounts of the persons who have got the drafts discounted and of those to whom cash was paid.

4.7.1 Many moneylenders advance loans against pawning of ornaments. If the debtor is not able to repay the loan in time, he would normally sell these ornaments. When there is an upward trend in prices of gold and silver, there would be profit on such sale also and therefore, the books maintained by the moneylender will have to be carefully examined, to verify whether the sales have been shown at the prevailing market rates.

4.7.2 The Assessing Officer should ask for details of debtors or borrowers with the names of debtors, dates and amount of loan, types of securities offered, and accepted, securities returned or sold by the lender as also repayments made by the borrower. This is especially important where bad debts are claimed by the moneylender.

4.7.3 One of the effective checks to determine the correct interest income is to find out the effective rate of interest charged and compare the total interest amount with the total or average amount of advances outstanding during the year as well as comparative market rates.

5. It is relevant to mention here that Section 69D of the Income-tax Act, 1961 provides that if any amount is borrowed from any person on a hundi or any amount due on it is repaid to any person, otherwise than through an account payee cheque drawn on a bank, the amount so borrowed or repaid shall be assessed as the income of the taxpayer borrowing or repaying the said amount, for the previous year in which the amount is borrowed or repaid. This will also apply to the amount of interest paid on the amount borrowed on hundis. Provisions of this Section are explained in Circular No. 208 issued vide F.No. 208/7/76-IT(A-II) dated 15/11/1976. The Board has further issued a Circular No. 221 vide F.No. 208/25/76-IT (A-II) dated 6/6/1977, in which Board has stated that certain instances of the Darshani Hundi mentioned in the Circular would not attract provisions of Section 9D of the Act. The AO has also to act very carefully while applying the provisions of Section 69D, as the courts have consistently taken a view that only transactions of Hundis are covered under this Section and in other cases, the Section is not applicable. Therefore, in other cases, possibilities of application of Section 269SS/269T may be examined.

6. It is also relevant to mention here the change in the regulatory framework over the years and its effect on the indigenous banking sector. By amendment in 1963 a new Chapter III-B was inserted in the RBI Act with provisions to regulate the conditions on which deposits may

be accepted by the non-banking companies or institutions. But these provisions did not apply to individuals or firms who are not incorporated but still do business which is akin to that of banking.

6.1 In order to place some restrictions on the acceptance of deposits by unincorporated bodies, by the Banking Laws (Amendment) Act, 1983 (Act 1 of 1984), certain restrictions were brought in the RBI Act. The constitutional validity of the same was challenged but the same was upheld by the *Hon'ble Supreme Court in T. Velayudhan Achari and Another vs. Union of India and others* (1993) 2 SCC 582. However, the same did not have the desired effect and therefore, the RBI Act was further amended by the Amendment Act, 1997. The newly incorporated Section 45-S prohibits any person, being an individual or a firm or an unincorporated AOP, who is engaged in the activities relating to Banking and other activities specified therein from accepting public deposits. Further, any such deposits held by them as on the 1st day of April, 1997 shall be repaid after such deposit becomes due for repayment or within two years from the date of such commencement, whichever is earlier. The constitutional validity of this amendment was also upheld by the Hon'ble Supreme Court in the case of *Bhavesh D Parish vs. UOI* (2000) 24 SCL 454 (SC).

6.2 Therefore, after the above amendment in the RBI Act, the Indigenous bankers, who were all un-incorporated bodies, were prohibited from accepting public deposits, severely curtailing their capital base for lending. This change in the regulations has reduced the Indigenous banking to moneylending business with limited latitude available for bill discounting business.

Regarding the moneylending, the Constitution of India has conferred the power to legislate on matters relating to money lending and moneylenders to the States. Most of these states have enacted the laws while some of them, like Jharkhand, have banned the same. Many of these are comprehensive legislations providing detailed and stringent provisions for regulation and supervision of the money lending business. These legislations contain provisions aimed at protecting the borrowers from malpractices of the moneylenders.

6.3 The salient features of these legislations are:

a. All the moneylending legislations provide that moneylenders are required to register and obtain a licence. In case of business without registration, there is provision for penalties to be imposed on the moneylender. Further, almost all state laws also impose a bar on suits filed by unregistered moneylenders. It was also a settled position in law that the suits made by such unregistered moneylenders are not maintainable before the court of law.

b. Most State Acts include the advance of both money and kind within the definition of the term 'loan'.

c. Almost all the States have provisions requiring moneylenders to keep statement of accounts in the form and manner prescribed in the Rules. Moneylenders are also required in some states to file statement of accounts with the registering/ licensing authorities and generally they are required to do so annually. Another requirement is to furnish a statement of accounts to the borrowers as prescribed under the Rules. Some state laws enable the State authorities to inspect the books of accounts and related documents. Some States even have powers of search and seizure of books of accounts and documents relating to money lending. Most of the States also prescribe penalties

for the falsification of accounts/ entry of wrong sums in accounts.

d. Penalties for carrying on business without licence and for intimidating the debtors or interfering with their day-to-day activities, including the cognizability of such offences;

e. Interest rates chargeable by moneylenders are either fixed by Statute or the Statutes empower the respective Governments to fix the interest rate by issue of notification from time to time.

6.4 In view thereof, the relevant laws of the state may be studied and the information submitted by the money lenders to various authorities nominated under the Act may be collected for cross verification. Similarly, collection of information from the Civil Courts may also be considered in appropriate cases to verify the extent of business carried out by a moneylender i.e. information collected from this source may reveal transactions in dispute not recorded in the moneylender's books of account.

CHAPTER

2

Banking and Financial Institutions

THE STRUCTURE OF INDIAN BANKING SECTOR

A bank is a financial institution that provides banking and other financial services to their customers. A bank is generally understood as an institution which provides fundamental banking services such as accepting deposits and providing loans. There are also non-banking institutions that provide certain banking services without meeting the legal Banks are a subset of the financial services industry. A banking system also referred as a system provided by the bank which offers cash management services for customers, reporting the transactions of their accounts and portfolios, throughout the day. Indian banking industry has been divided into two parts, organized and unorganized sectors. The organized sector consists of Reserve Bank of India, Commercial Banks and Co-operative Banks, and Specialized Financial Institutions (IDBI, ICICI, IFC etc). The unorganized sector, which is not homogeneous, is largely made up of moneylenders and indigenous bankers.

TAXATION ISSUES IN BANKING SECTOR–FACTUAL & LEGAL INTERPRETATIONS THEREIN

During the course of assessment of banking companies, various issues have been identified and necessary adjustment to the returned incomes of the assessee banks have been made from time to time. While legal issues continue to dominate the assessment of banking companies, important factual issues have also been identified in concluded assessment proceedings. Various issues identified are enumerated hereunder:

1. Broken Period Interest.
2. Interest accrued but not due.
3. Disallowance under Section 14A.
4. Provision for Wage revision.
5. Provision for Amortization of Premium paid on Securities in HTM Category:
6. Allowability of claims under Section 36(1)(vii) and 36(1)(viia) of the Act:
   - 6.1 Overlap of 36(1)(vii), 36(1)(viia) and 36(2).
   - 6.2 Allowability of claim of deduction in respect of "Provisions for standard asset".

6.3 Definition of Rural Branches

6.4 Allowability of assessee bank's claim in view of Vijaya Bank decision

7. Penalty paid by Banks to the Reserve Bank of India
8. Interest on NPA/ NPI as per S43D r.w.s. 6EA
9. Leased assets
10. Applicability of 115JB/ MAT Provisions
11. Deferred payment guarantee commission
12. Deduction claimed by Co-operative banks
13. Special Reserve–Deduction under Section 36(1) (viii)
14. Loss on foreign exchange transactions
15. Disallowance under Section 43B
16. Recovery in written off accounts
17. Provision for pension
18. Income from foreign branches
19. Loss on sale of assets to ARC
20. Provision for restructured advances, Diminution in fair value of assets
21. Employee stock options
22. Interest paid on Innovative Perpetual Debt Instruments
23. Bad debts claim on credit card business under Section 36(1)(vii)
24. Loss on revaluation of securities
25. Provision for foreign taxes
26. Interest on refunds issued under the Income-tax Act
27. For Foreign Banks having Branches in India

27.1 Head office expenses

27.1.1 NRI Deposit mobilisation expenses

27.1.2 Salaries to expatriate employees

27.1.3 Expenditure on group credit risk management

27.2 Interest received from Head Office/ foreign branches.

27.3 Rate of tax.

27.4 Interest paid to HO.

27.5 Fees received from overseas branches.

27.6 Refurbishment expenses

27.7 Interest in suspense account charged to tax denying the benefit of Section 43D

27.8 Data processing charges paid to HO/ Regional Centres

27.9 Transfer pricing adjustments

27.9.1 Share of profit in relation to ECBs and other products

27.9.2 Royalty paid on brand

27.9.3 Direct costs attributable to India branch and head office expenses

The various issues listed above are discussed in details here forth.

1. BROKEN PERIOD INTEREST

As far as the categorization and valuation of banks' investment portfolio is concerned the key features of RBI guidelines are as under:

The investment portfolio of a bank normally consists of both "approved securities" (predominantly Government securities) and "others" (shares, debentures and bonds). The Bank should classify their entire investment portfolio under three categories *viz.* 'Held to Maturity' (HTM), 'Held for Trading' (HFT), and 'Available for Sale' (AFS). *HTM includes securities acquired with the intention of being held up to maturity; HFT includes securities acquired with the intention of being traded to take advantage of the short-term price/ interest rate movements; and AFS refers to those securities not included in HTM and HFT.*

The guidelines of RBI with regard to securities Held to Maturity (HTM) given in the Master Circular applicable to the previous year relevant to the current assessment year state the following:

i. The securities acquired by the banks with the intention to hold them up to maturity will be classified under 'Held to Maturity (HTM)'.

ii. Banks should decide the category of the investment at the time of acquisition and the decision should be recorded on the investment proposals.

Thus, the RBI guidelines make the fact clear that the securities held to maturity are identified and categorized at the time of acquisition. i.e. they are the investments of the bank and are as such taken to the balance sheet of the bank.

Banks claim that when a Bank purchases securities with an intention to hold them as HTM, the purchase price paid includes two components namely, the price of the security and the broken period interest. The banks further claim that the interest component of the purchase price paid-for the broken period cannot be considered as the cost price of the security but needs to be considered as a separate revenue item. Moreover, the banks also claim that the broken period interest has to be adjusted against the other interest income earned by the Bank.

The banks usually rely on the case of *American Express International Banking Corpn. vs. CIT* (2002) 258 ITR 601 (Bom.) in this regard. However, the facts of the case are distinguishable since the Hon'ble High Court of Bombay has based its Judgment on the premise that the broken period interest was charged to tax under the head of Business Income.

It is pertinent here to consider the observations of the Hon'ble Supreme Court of India in the case of *United Commercial Bank Ltd. vs. CIT* (1957) 32 ITR 688 (SC), wherein it was clarified that the interest on securities held by the bank cannot be treated as business income but has to be assessed to tax as interest income on securities i.e., under Section 56 of the present Income-tax Act, 1961. Moreover, the Hon'ble Supreme Court of India in the case of *Vijaya Bank Ltd. vs. Addl. CIT.* (1991) 187 ITR 541 (SC) clearly stated that broken period interest is part of capital outlay for acquisition of securities. Further, the Rajasthan High Court in the case of *CIT vs. The Bank of Rajasthan Limited*, came to the conclusion that the amount paid by the bank towards broken period interest on securities purchased by it is not an allowable business deduction but has to be considered as the purchase price paid for acquiring the securities after considering the case of *American Express International Banking vs. CIT* (258 ITR 601) in detail.

Furthermore, the jurisdictional High Court of Bombay in the following cases clearly held that interest income on securities cannot be considered as business income of a bank:

i. *CIT vs. Banque National de Paris* (1999) 237 ITR 278 (Bom.)

ii. *Banque National de Paris vs. CIT* (1999) 237 ITR 518 (Bom.)

iii. *Mercantile Bank Ltd. vs. CIT* (2001) 252 ITR 225 (Bom.)

In this connection it is necessary to go into the background of the issue. Prior to 01/04/1989, the income from securities was assessable under the head 'Interest on Securities' (Clause B of Section 14 of the Income-tax Act). This head of income was omitted w.e.f. 01/04/1989 but, at the same time, Clause (28B) of Section 2 and Clause (id) of Section 56(2) were inserted by the Finance Act of 1988. Interest on securities are now defined under the Income-tax Act under Clause (28B) of Section 2 of the Income-tax Act as under:

(28B) "Interest on securities" means:

i. *Interest on any security of the Central Government or a State Government;*

ii. *Interest on debentures or other securities for money issued by or on behalf of*

a local authority or a company or a corporation established by a Central, State or Provincial Act.

As far as taxation of interest on securities is concerned, Clause (id) of Section 56(2) states as under:

"(id) income by way of interest on securities, if the income is not chargeable to Income-tax under the head "Profits and gains of Business or Profession"

Thus, the interest on securities, which does not fall under the head Profits and Gains of Business or Profession, has to be brought to tax under the head 'Income from Other Sources'. The banks usually rely on the case of *CIT vs. Cocananda Radhaswami Bank Ltd.* (57 ITR 306(SC)) and further submit that it has been settled by a series of decisions of the High Courts and the Hon'ble Supreme Court of India that the securities held by the Banks may constitute as either stock-in-trade or investment. If the argument of the bank is applied in its case, then as can be seen from the discussion securities Held to Maturity (HTM) need to be considered as its investments and the securities held under the head Held for Trade (HFT) and Available for Sale (AFS) as its stock-in-trade.

The guidelines of the RBI with regard to trading of securities under the head 'HFT and AFS', in contra-distinction to those on HTM, are as follows:

"Available for Sale & Held for Trading

i. *The securities acquired by the banks with the intention to trade by taking advantage of the short-term price/ interest rate movements will be classified under 'Held for Trading (HFT)'.*

ii. *The securities which do not fall within the above two categories (HTM & HFT) will be classified under 'Available for Sale (AFS)'.*

iii. *The banks will have the freedom to decide on the extent of holdings under HFT and AFS. This will be decided by them after considering various aspects such as basis of intent, trading strategies, risk management capabilities, tax planning, manpower skills, capital position.*

iv. *The investments classified under HFT would be those from which the bank expects to make a gain by the movement in the interest rates/ market rates. These securities are to be sold within 90 days.*

v. *Profit or loss on sale of investments in both the categories will be taken to the Profit & Loss Account."*

Current assets are defined as those assets that are reasonably expected to be realized in cash or sold during the normal operating cycle of a business entity or within one year whichever is longer. On the other hand Investments are held in anticipation of earning a long term return. The securities held under HTM category are long term and are valued at cost price or face value whereas, securities held under HFT and AFS categories are short term and are valued cost price or market price, whichever is lower. Thus, the securities held under HTM have all the characteristics of investment and the securities held under the head HFT and AFS categories have all the characteristics of current assets and they need to be assessed as such under the Income-tax Act. In view of the above, the investment made in acquiring securities under the head HTM has to be considered as the purchase price of the security and under no circumstances, the purchase price can be divided further into components of price and broken period interest as observed by the Hon'ble Supreme Court in the case of *Vijaya Bank (supra)*.

Once it is concluded that interest income on the securities held under the head 'HTM' has to be assessed under Section 56 of the I.T. Act, the only deduction that can be allowed is as per Clause (iii) of Section 57 of the I.T. Act. is reproduced below:

> *Section 57 (iii): "any other expenditure (not being in the nature of capital expenditure) laid out or expended wholly and exclusively for the purpose of making or earning such income."*

In the given circumstances, any claim for deduction from the interest on securities held under HTM category by the assessee cannot be sustained because the assessee is in no position to show that any reasonable expenditure has been incurred for the purpose of realizing interest on securities. The amounts claimed by the banks for deduction are not, thus, expended for the purpose of realizing the interest and are, therefore, not allowable as deductible expenditure.

2. INTEREST ACCRUED BUT NOT DUE

In their books of account, the assessee normally recognise income from interest on securities on a day to day accrual basis. However, in the returns filed, it is often claimed that the interest which has not become due for payment during the previous year should not be included as the income. Income accrues as and when the assessee acquires a right to receive such income or the right becomes vested in it. In the case of the Government securities etc. although interest becomes due for payment only at six monthly intervals, such interest certainly accrues on day to day basis. When the assessee purchases certain securities & the amount payable for purchase is decided after taking into consideration the amount of interest which would accrue on day to day basis from the last date of payment of interest to the date of purchase. Similarly, when the assessee sells the securities, the sale value is determined taking into consideration the interest accrued for the broken period. If the securities had been sold on the last day of the accounting year, the assessee would have received the entire amount of accrued interest along with the sale consideration. So on the last day of the accounting year the assessee had a right to receive the entire accrued interest on the securities held by it. Thus, since the right to receive such interest vested with the assessee, clearly that such interest has accrued to the assessee and the same is assessable in its hands.

For example assessee purchases a security on 1st January and due dates for interest payment are 1st November and 1st May. It is further presumed that the interest for this six month period is six rupees. Thus, assessee will have to pay broken period interest for two months on purchase of above security which is Rs. 2 and will be debited in P&L account as interest paid. On 31st March, the interest accrued on this security will be Rs. 5 which is included in interest income on accrual basis in the books of accounts. However, in the return of income this interest of Rs. 5 will be excluded as the interest will become due on 1st May i.e. after the end of F.Y. Thus, interest of Rs. 2 spent on purchase of this security has been booked as expenditure but the corresponding income has not been offered for Income-tax purposes despite being included in books of accounts on accrual basis.

On a plain reading of provisions of Section 145(1), it would be clear that once an assessee regularly follows a particular method of accounting from which income can properly be deduced, and which is in accordance with the accounting standards provided by Central Government and based on sound and acceptable accountancy principles, the method of accounting selected by assessee is binding on assessee as well as on Income-tax Authorities. The word used in Section 145(1) is "shall" and there does not appear to be any reason to read the same as may. Thus, when assessee itself has included income on securities,

on accrual basis, in its books of account under a regularly employed method of accountancy, which is in accordance with accounting standards and accepted accountant principles, neither it is open for assesses to keep this method of accountancy aside for offering "total income" for taxation as per charging provisions, nor it is open for the AO to accept income on any other basis then the income computed on the basis of such accounts.

Thus, the following argument is to be considered: On purchase of securities, the purchase price is claimed in two parts-(a) as cost of purchase and (b) broken period interest. Against this, in credit side of trading account the assessee has shown receipts/ due interest and also interest accrued but claimed as not becomes due. If the figure of interest accrued but not due is eliminated from the trading account, it will not balance account properly and not show the entire income from the investment expenditure which in turn will totally distort the picture of profit offered for taxation. The assessee prepares its account on mercantile system, includes the accrued interest in total income and claimed entire cost on purchase of securities including the broken period interest as expenditure. RBI Guidelines ensure that there is no uncertainty as to realizing such interest which is shown accrued by the bank. No such uncertainty has been reported in the notes to the annual accounts nor is any adverse comment on the same found in auditor's report. When from the point of view of all accounting standards/ principles such entry of receipt can be taken as part of income, there is no reason why the same shall not be taken as income accrued from Income-tax point of view, (especially when all the standard account practices are conservative towards treating an item as income). Further, the elimination of interest accrued but not due also violates the matching principles. Further, while computing the tax free interest income from bonds, the assessee itself is adding accrued interest to the tax free income.

To arrive at above conclusion, the support has also been derived from the following judgments:

a. Any adjustment in commercially computed income could be allowed if there is a legal fiction available under the law otherwise no such adjustments should be made. The same principle was also confirmed by the Hon'ble Supreme Court in the case of *CIT vs. Shri Goverdhan Limited* (69 ITR 675 SC).

b. The arguments made on the issue so far, are also supported by the decision of Hon'ble Bombay High Court in the case of *Taparia Tools Ltd.* (260 ITR 102*)* wherein it is held that in order to determine the net income of an accounting year under the Mercantile System of Accounting, the revenue and other incomes are to be matched with the cost of resources consumed. Under this matching concept, revenue and income earned during an accounting period irrespective of actual cash flow is to be compared with the expenses incurred during the same period. Since the broken period interest paid on purchase of a security is being debited to the Profit & Loss Account, the corresponding income needs to be accounted for and taxed, to follow above decision.

c. It may also be mentioned that it has been held by Hon'ble Supreme Court in the case of *State Bank of Travancore* (158 ITR 102) the notion of real income cannot be brought into trade where the income has accrued to the accounts of assessee and there is no indication by the assessee treating the amount as not having accrued.

3. DISALLOWANCE UNDER SECTION 14A

As per the provisions of Section 14A r.w. Rule 8D disallowances of expenditure in earning exempt income is to be made if the AO is satisfied that such expenditure was incurred but not disallowed by the assessee. The disallowance is to be made even if the assessee contends that

no expenditure has been incurred in earning exempt income.

Assessee banks usually make large volume investments in various kinds of market instruments. Such investments are made for different holding periods, both short term and long term. These investments cannot be managed without inherent expenses since no investments can be made without market analysis and expertise. The assessee could not have got the market expertise and the necessary staff for free and has to necessarily incur expenditure. It is not possible without sufficient expertise as to selection of securities and timely swaps. With increase in technicalities involved in market operations the assessee is bound to have expert advice and necessary staff to act in a time bound manner for proper investments. The assessee would be in receipt of various daily reports, fortnightly reports and monthly reports at regular intervals so that the assessee can take informed decisions regarding deployment/ redemption of their investments in various schemes. These inputs have costs in terms of substantial time as well as cost on account of conveyance, travelling, telephone/ mobile bills, stationery etc. It is difficult to ascertain such cost in quantitative terms. However the cost on approximate basis has to be considered for the purpose of disallowance. Moreover, in view of the decision of ITAT Special Bench, Mumbai in the case of *M/s. Daga Capital Management Pvt. Ltd.* (ITA No. 8057/Mum/03), disallowance Under Section 14A r.w. rules needs to be made. Prior to Rule 8D, the apportionment of expenditure was at the discretion of Assessing Officer. But, now Rule 8D has prescribed a formula for calculation of disallowance under Section 14A and the same is binding in nature. Rule 8D can be applied from AY 2008–09 as held by the *Bombay High Court in the* case of *Godrej & Boyce Mfg Co Ltd* (47 DTR 177).

However, in the recent times, post the judgement of the *Hon'ble SC in the case of Reliance Power and Utilities,* where the court has said that if there are interest-free funds available to an assessee sufficient to meet its investments and at the same time the assessee had raised a loan, it can be presumed that the investments were from the interest-free funds available, the application of Rule 8D(ii) has come into question. However, every case may be examined on merit and additions be made.

A landmark judgement in recent times is that of the Hon'ble SC in the case of *Maxopp Investments* (91 taxmann.com 154). The court has held that the purpose of investment (as stock in trade etc.) is immaterial for the purpose of Section 14A. Expenses have to be apportioned as per the provisions of Section 14A read with Rule 8D in all cases where dividend income is earned.

4. PROVISION FOR WAGE REVISION

This issue found in public sector banks, is fairly contentious and deals with the point at which liability to pay has accrued to the assessee bank. Provision for wage revision is usually made by the assessee bank while negotiations for wage increase are being made by the federation of banks with Workers' Unions. Pending the finalisation of the agreement, the Assessee bank debits "provision for wage revision" year on year, and claims the same as deduction. The bank argues that the liability accrued to it during the year, however, pending finalisation of agreement, the exact amount of the liability is not crystallized and hence may be considered as contingent. Arguments in Department's favour are as follows:

a. The essences of accrual are reasonable certainty and possible quantification of the liability. In the event of agreement pending finalization, the assessee's calculation for liability accruing to it has not been finalized and hence the liability has not been crystallized. Therefore, it is contingent liability which is not allowable under Section 37(1) of the Income-tax Act.

b. The assessee banks usually rely upon the decision of the SC in *NTPC and BHEL*. However, on the issue of wage revision, if the agreement has not been signed yet and the quantum of liability is not determined, the process has nowhere reached finality and hence the facts are distinct from the decisions mentioned above.

c. Instruction No. 17/2008 dated 26 November 2008 issued vide File No. 228/3/2008–ITA–II, the CBDT has also issued an instruction wherein vide Para (xi), it has been stated that: *Section 37 of the Act envisages that an amount debited in the Profit & Loss Account in respect of accrued or ascertained liability only is an admissible deduction, while any provision in respect of any unascertained liability or a liability which has not accrued, do not qualify for deduction. However, it has been found that Banks are claiming provisions on different accounts, probably under the RBI guidelines (e.g. Provision for wage arrears for which negotiations are yet to be finalized, provision for standard asset etc.…) A contingent liability cannot constitute deductible expenditure for the purposes of Income-tax Act. Thus, putting aside of money which may become expenditure on the happening of an event would normally not constitute an allowable expenditure under the Income-tax Act. The AOs should verify such claims as to whether these are admissible as per the Income-tax Act.* Thus, the claim of assessee bank is merely based on certain estimates where the final quantum of liability incurred has not been arrived yet. Also, importantly, the employees are not in position to claim the upward wage from the Bank till the above process of finalization of agreement by the Bank of the same is complete. Thus, it can be held that the "provision for wage revision" is a contingent liability and is not allowable.

5. PROVISION FOR AMORTIZATION OF PREMIUM PAID ON SECURITIES IN HTM CATEGORY

The CBDT Instruction No. 17 allows depreciation on investment in HFT and AFS category but it is silent on the treatment of investment classified in HTM category this gives rise to above issue.

A. The loss on revaluation of investment/ provision for amortization of premium is claimed on following grounds by the Banks:

a. In accordance with guidelines issued by the Reserve Bank of India (RBI), investments in Held to Maturity (HTM) category should be carried at acquisition cost. In case the purchase price is higher than the face value, the premium should be amortised over the remaining period of maturity of the security.

   In view of the above, the Banks amortize loss in respect of amortization of investments held in HTM category.

   The Bank claim that investments are trading securities, though, following RBI instructions, securities have been classified under various categories. Such classification does not take away the fact that all securities are trading securities of the Bank. It is, therefore, claimed that depreciation provided on investments under HTM category, by way of amortization of premium is allowable as a deduction like other securities.

b. They also support their claim citing that the concept of deferred revenue expenditure for Income-tax purposes has been accepted by the Supreme Court in the case of *Madras Industrial Investment Corporation Ltd. vs. CIT* (1997) (225 ITR 802). In this case, the Hon'ble Supreme Court held that the proportionate amount of discount relatable to issue of debentures was tax deductible over the period of the debentures.

c. It is also claimed that the amortization of premium in respect of investments held in HTM category is another method of valuation. This method of valuation has been prescribed by the RBI and is consistently followed by the Bank. The Supreme Court in United Commercial Bank's case referred to above has held that a method of accounting adopted by the taxpayer consistently and regularly cannot be discarded by the departmental authorities on the view that he should have adopted a different method of keeping accounts or of valuation. Accordingly, the Banks are entitled to the amortization of premium in respect of securities categorized as HTM.

B. There is no dispute that this amortization in regard to securities held in the HTM category is made as per guidelines of the RBI which also permit to ignore the difference in case the cost price is less than the face value. The question arises under which provision of the Act such amortization can be allowed as deduction. In this regard following facts are important:

a. In respect of HTM securities, the banks follow two different systems which are inconsistent with each other. When the purchase price is less than the face value at which the security is ultimately sold, the difference is booked as profit only in the year of sale. But when the cost price is more than the face value, the loss is not booked in the year of sale but is spread over the period of holding. If the securities are held as investment, there is no question of allowance of any amount till such time as they are sold or redeemed. Even if these securities are held as stock-in-trade, as per RBI's guidelines, the method of valuation of closing stock adopted in respect of securities in HTM category is cost price which is one of the two recognized methods of valuation. Since the cost price is constant, there is no question of deduction of any amount under the commercial principles even if HTM securities are accepted to be stock-in-trade of the appellant. Whatever loss is suffered on sale of redemption of securities that will constitute the loss of the year in which they are sold or redeemed. In between, no amount can be allowed under the provisions of Section 145. By claiming amortization, the banks seek to neutralize the effect of valuing the securities in HTM category on cost price which is one of the two recognized methods of valuation of the closing stock.

b. It cannot be the effect of the RBI guidelines that the total income for the purpose of Income-tax has to be computed in accordance with these guidelines. These are only meant as guiding factors to determine the commercial profit for various purposes on conservative principles. The total income has to be computed under the mandate of the Income-tax Act and a recognized system of accounting has to be followed under Section 145 of the Act.

c. It may be worthwhile to mention that in the RBI circular it is clearly noted that the above accounting treatment does not take into account taxation implications and hence the banks should comply with the requirements of Income-tax Authorities in the manner prescribed by them. The findings given by Hon'ble Supreme Court in a very recent judgment delivered in January, 2010 in the case of *M/s. Southern Technologies Ltd. vs. JCIT* in Civil Appeal No. 1337/ 2003 which were referred earlier also in the order, are also very relevant. In this case, the assessee which is an NBFC had created a provision for NPA, which in terms of RBI guidelines was debited to

Profit & Loss Account and was claimed in the Income-tax Return. The Hon'ble Supreme Court has held that the above provision is not allowable. With regard to RBI Guidelines, it has been observed by Hon'ble Supreme Court that;

"We need to emphasize that the RBI Guidelines has nothing to do with the accounting treatment or taxability of "Income" under the Income-tax Act.

The two i.e. I.T. Act and RBI Guidelines operate in different fields.....Ultimately, the nature of transaction has to be examined in each case. The authority has to examine the nature of expense/ loss. Such examination and finding thereof will not depend upon presentation of expense/ loss in the financial statement. In our view, the RBI directions and I.T. Act operate in different fields."

The above reference to the specific Clause in RBI circular clearly mention that the prescribed accounting treatment does not take into account the applicability of I.T. law, and decision of Hon'ble Supreme Court makes it very clear that RBI Guidelines themselves will not decide taxability of the income.

6. ALLOWABILITY OF CLAIMS UNDER SECTION 36(1)(vii) AND 36(1)(viia) OF THE ACT

The issues relating to deduction under Section 36(1)(vii) and 36(1)(viia) are complex and therefore, in Instruction No. 17/2008 dated 26/11/2008 certain guidelines have been provided to deal with these deductions which are as under:

i. *Under Section 36(1)(vii) of the Act, deduction on account of bad debts which are written off as irrecoverable in the accounts of the assessee is admissible. However, this should be allowed only if the assessee had debited the amount of such debts to the provision for bad and doubtful debt account under Section 36(1)(viia) of the Act, as required by Section 36(2)(v) of the Act.*

ii. *While considering the claim for bad debts under Section 36(1)(vii), the Assessing Officer should allow only such amount of bad debts written off as exceeds the credit balance available in the provision for bad and doubtful debt account created under Section 36(1)(viia) of the Act. The credit balance for this purpose will be the opening credit balance i.e., the balance brought forward as on 1st April of the relevant accounting year.*

Section 36(1)(viia) of the Act provides that in respect of any provisions for bad and doubtful debts of the type referred to in that sub-Clause made by a bank, an amount not exceeding 5 per cent up to 31st March, 2003 and thereafter 7.5 per cent of the total income (computed before making any deduction under this Clause and Chapter VIA of the Act) and an amount not exceeding 10 per cent of the aggregate average advances made by 'rural branches' of such banks computed in the manner prescribed under the Income-tax Rules, 1962, shall be allowed as deduction.

The various issues encountered in respect of Section 36(1)(viia) and Section 36(1)(vii) are as follows:

Let us consider a domestic Scheduled bank whose financial position is as follows:

"A" Bank

i. P&L A/c: (Year 1):

Dr.	Cr.
Provision for bad and doubtful debts under Section 36(1) (viia)–Rs. 100/-	

In Year 1, "A" bank has *created a provision* under Section 36(1)(viia) and credited an amount of

Rs. 100/- to the same and claimed it as deduction in P&L A/c.

Provision under Section 36(1)(viia) of Rs. 100/- has been calculated as follows:

Let us assume that the total income of the bank is Rs. 1000/- (computed before deduction under Chapter VI A). Hence, 7.5% of total income is Rs. 75/-

Also, if aggregate average advances made by rural branches of the bank is Rs. 250/-. Hence, 10% of the same is Rs. 25/-. (computed in accordance to *Rule 6ABA).*

Therefore, the total provision in Section 36(1)(viia) is Rs. 75/- + Rs. 25/- = Rs. 100/-

Hence, in Year 1, "A" will be allowed a deduction of Rs. 100/- under Section 36(1)(viia) of the Act.

{*IN CASE Where…*

Amount "Actually" to be Allowed as Deduction under Section 36(1)(viia)

In a situation, the calculation according to the provision under Section 36(1)(viia) comes to Rs. 100/- however, *the bank has created a provision and debited only an amount of Rs. 95/- to the P&L.* In that situation, the bank is eligible to claim only a deduction of the amount actually credited to the provision account, i.e. *the lower of: the amount calculated and the amount of provision actually created* is allowed as deduction.}

Also, if during assessment proceedings, the assessee bank's total income is revised to Rs. 1500/- then according to the calculation provided in Section 36(1)(viia) of the Act, assessee is entitled to deduction of:

10% of Rs. 250/- = Rs. 25/- (rural advances, as mentioned above)

+

7.5% of Rs. 1500/- (revised total income)
= Rs. 112.5/-

= Rs. 137.50/-

However, the assessee has created a provision and credited only Rs. 100/- to account under Section 36(1)(viia) of the Act. The amount of deduction allowable as deduction under Section 36(1)(viia) of the Act is Rs. 100/- and NOT Rs. 137.50/-

Year 2:

It is to be remembered here that provision under Section 36(1)(viia) is a "legacy" provision, to which amounts are credited every year, and is not a stand alone provision for the year under consideration. Hence, for Year 2, the opening credit balance of the provision under Section 36(1)(viia) is Rs. 100/- (carried forward from earlier years). In year 2, if the bank has credited a further amount of Rs. 90/- to provision under Section 36(1)(viia) (calculation as above), and claimed the same as deduction under Section 36(1)(viia)

Now, in Year 2, let us say the bank has written off a certain amount as "bad debts" and claimed the same as deduction under Section 36(1)(vii) of the Act.

Situation 1: Firstly, let us say the amount of bad debts written off in Year 2 is Rs. 80/- According to Section 36(1)(vii), *"the amount of deduction relating to any debt or part thereof shall be limited to the amount by which such debt or part thereof exceeds the credit balance in the provision for bad and doubtful debts account made under that Clause."* The credit balance for this purpose is the opening credit balance (as clarified in Instruction 17/2008). In the present situation, amount of bad debts written off is Rs. 80/- and the opening credit balance of the provision account is Rs. 100/- Hence, no deduction is allowed under Section 36(1)(vii) of the Act.

Situation 2: Let us say the amount of bad debts written off is Rs. 120/- the opening balance of the provision account is Rs. 100/- Thus, the amount of bad debt as "exceeds the credit balance" of the provision is Rs. 120–Rs. 100 = Rs. 20/- will be allowed as deduction under Section 36(1)(vii) of the Act.

It is mentioned here that the amount credited to the provision under Section 36(1)(*viia*) (of Rs. 90/-) has no bearing on the amount of deduction claimed in the present year under Section 36(1)(vii) of the Act.

The following transactions reflect in the provision for bad and doubtful debts for year 2:

1. Credit of new provision under Section 36(1)(viia) for year 2–Rs. 90/-
2. Debit of bad debts in year 2–Rs. 80 (situation 1) and Rs. 120 (situation 2)
3. Closing credit balance at the end of year 2 is modified accordingly–situation 1–Rs. 110. (100 + 90–80) and situation 2–Rs. 70/- (100+90–120)

6.1 Overlap of 36(1)(vii), 36(1)(viia) and 36(2)

It is important to read and understand the provisions of 36(1)(vii) and 36(1)(viia) of the Act in conjunction with the provisions of 36(2) of the Act.

6.1.1 An interesting case has come up in recent times, for banks who have not created a provision under Section 36(1)(viia) of the Act and have not claimed any deduction for the same. The issue arises when such a bank writes off an amount of bad debts and claims the same as deduction under Section 36(1)(vii) of the Act.

Should the entire amount be allowed as a deduction, considering the opening credit balance of the provision account as nil, or should the same be disallowed, in accordance to 36(2)(v)?:

The proviso to Section 36(1)(vii) reads that in the case of (an assessee) to which Clause (viia) applies, the amount of the deduction relating to any such debt or part thereof shall be limited to the amount by which such debt or part thereof exceeds the credit balance in the provision for bad and doubtful *debts account made under that Clause.*

In this case-the provision for bad and doubtful debts has NOT been created.

The legislature clarified in Section 36(2)(v) and further categorically settles the issue by observing that, no such deduction shall be allowed unless the bank has debited the amount of such debt or part of debt in that previous year to the provisions for bad and doubtful debts account made under that Clause Section 36(2)(v) reads as follows:

> *(v) where such debt or part of debt relates to advances made by a bank to which Clause (viia) of Sub-section (1) applies, no such deduction shall be allowed unless the bank has debited the amount of such debt or part of debt in that previous year to the provisions for bad and doubtful debts account made under that Clause.)*

6.1.2 There has also been considerable confusion as to whom the provisions of Section 36(1)(viia) of the Act apply. Whether the provision can be created by banks who have no rural branches and have thus made no rural advances, also whether the provision applies to foreign banks in India. *Various Judicial Pronouncements have answered–yes.*

Importantly, the full Bench of Kerala High Court has since been delivered on the issue in the same case, on 16th December, 2009. In this case, it was held that;

> *"On a close scrutiny of Proviso of Section 36(1)(vii), we are of the view that for the application of ceiling provided therein, the legislature does not make any distinction between provision created in respect of advances by rural branches and advances made by other branches of the bank. In fact, what the Proviso refers is "to the bank to which Clause (viia) applies "and not to the debt in respect of which provision is created and claimed as deduction under Clause (viia). In other words, the proviso to sub-Clause (vii) which is an exception to the main Clause by way of ceiling of*

the eligible deduction in the first place, applies to only such category of the bank to which Clause (viia) applies. This means that such of the banks which are entitled to claim deduction of provision for bad debt under Clause (viia) will be covered by the Proviso to Clause (vii) irrespective of the nature of advances, with respect to which the bad debt written off is claimed as deduction.

Thus, Section 36(1)(viia) of the Income-tax Act contains three sub-clauses, i.e. sub-Clause (a), sub-Clause (b) and sub-Clause (c) and only one of the subclauses i.e. sub-Clause (a) refers to rural advances whereas other sub-clauses do not refer to the rural advances. In fact, foreign banks generally do not have rural branches. Therefore, the provision for bad and doubtful debts account made under Clause (viia) of Sub-section (1) of Section 36 and referred to in proviso to Clause (vii) of Sub-section (1) of Section 36 and Clause (v) of Sub-section (2) of Section 36 of the Income-tax Act applies to all types of advances, whether rural or other advances and all types of banks.

6.1.3 At this juncture, let us also examine the recent amendment to 36(1)(vii) by way of insertion of Explanation2 to 36(1)(vii), which reads as follows:

[Explanation 2.—For the removal of doubts, it is hereby clarified that for the purposes of the proviso to Clause (vii)of this Sub-section and Clause (v)of Sub-section (2), the account referred to therein shall be only one account in respect of provision for bad and doubtful debts under Clause (viia) and such account shall relate to all types of advances, including advances made by rural branches;]

The above amendment was brought into effect from 01/04/2014 (hence applicable to AY 2014–15) and was done to counter the decision of the Hon'ble SC in the case of *Catholic Syrian Bank* in which the court had held that the assessee was entitled to create two different provisions under Section 36(1)(viia) and the set off bad debts corresponding to rural and non rural advances separately against the opening balances of each of the provisions.

6.2 Allowability of Claim of Deduction in Respect of "Provisions for Standard Asset".

The deduction for provisions under Section 36(1)(viia) of the I T Act in respect of bad & doubtful debts, though is available in respect of 7.5% of the total income and 10% of the rural advances, it is necessary that the provision is created in the books. The banks are creating provision in pursuance of RBI guidelines in respect of following categories of assets.

i. Standard assets.

ii. Doubtful assets.

iii. Losses.

Though the deduction under Section 36(1)(viia) is available only in respect of "Provision for bad & doubtful debts", the banks are claiming deduction in respect of provisions for even the standard assets mainly on the following grounds:

It is clear that the provision for NPAs created in accordance with RBI Guidelines on outstanding non-performing advances as substandard assets and doubtful assets. It also indicates that no provision is required for standard assets as the standard assets are not included in the categories of substandard and doubtful assets. The provisions on substandard and doubtful assets can only be claimed as provisions for bad and doubtful debts.

But the fact remains that even if as per the guidelines of RBI, the assessee can make the provision on different categories of assets which does not mean that the provisions made for standard assets is a provision for bad and doubtful debts. The provision made on loss assets, substandard assets and doubtful assets can only be taken as provisions for bad and doubtful debts.

6.3 Definition of Rural Branches

Rural Branch means a branch of a schedule bank or a non-scheduled bank, which is situated at a place the population of which is not more than 10,000 as per the *Latest Census.* (Rule 6ABA). (what is latest census is also a matter of debate). For working out the aggregate average advances by rural branches of a bank, the assessee should list down the branch(es) and categorise 'rural branches' which falls within the definition in Explanation (ia) below to Section 36(1)(viia). It has been found in some of the banks that the deduction was also claimed in respect of branches where the population was more than the prescribed population. It is advisable that a chart of such Rural Branches should be prepared in the following format to comply with the provisions of the both Sections 36(1)(viia) and rule 6ABA prescribed.

6.4 Allowability of Assessee Bank's Claim in View of Vijaya Bank Decisions

The allowability of assessee's claim under Section 36(1)(vii) is discussed as under:

a. The assessee has claimed bad debts under Section 36(1)(vii) by placing reliance on the decision of the Hon'ble Supreme Court in the case Vijaya Bank reported in wherein the Hon'ble Court has interpreted write-off as simultaneous debit provisions to profit and loss account and reduction of loans and advances from the asset side of the balance sheet by such provision amount. In the aforesaid judgement, the Hon'ble SC has laid down what constitutes as write-off.

b. The deduction under Section 36(1)(vii) is not absolute and subject to the conditions prescribed in the said Section itself. The Hon'ble Supreme Court in the case of *Vijaya Bank (supra)* held that if bad debt written off is debited to profit and loss account and the amount of write-off is reduced from the loans and advances or debtors in the balance sheet, the deduction on account of write-off of bad debts is allowable without closing the borrowers account individually. However, the findings and the decision of the Hon'ble Apex Court in this case are confined to the provisions of Sub-section 36(1)(vii) In the said decision the scope and applicability of Clause (viia) of Sub-section 36(1), Clause (v) of Sub-section 36(2) and proviso to Clause (vii) of Sub-section 36(1) have not been examined or considered.

c. While discussing the allowability of assessee's claim, it is pertinent to consider the first proviso to Section 36(1)(vii) which reads as:

   Provided that in the case of an assessee to which Clause (viia) applies, the amount of the deduction relating to any such debt or part thereof shall be limited to the amount by which such debt or part thereof exceeds the credit balance in the provision for bad and doubtful debts account made under that Clause:

   In the case of the *assessee bank* which is a scheduled bank within the meaning of Explanation (ii) to Section 36(1)(viia), there can be no other interpretation that the provision of Section 36(1)(viia) compulsorily apply to the assessee bank. The mandatory applicability of the Section 36(1)(viia) is clear from the wording of the Section which reads as "36(1) The deductions provided for in the following clauses shall be allowed in respect of the matters dealt with therein:" Thus, the claim of the assessee bank that provisions of Section 36(1)(viia) does not apply to it, are to be rejected.

d. Thus, first proviso to Section 36(1)(vii) applies to the assessee bank in view of its claim under Section 36(1)(vii). Section 36(1)(viia) represents specific provision

for the banking industry in view of the nature of their business and Sections 36(1)(viia) and 36(2)(v) seek to prevent claim of double deduction on account of the same bad and doubtful debt. Hence, it is essential that the provisions of these Sections be complied with.

e. Further, with respect to the assessee banks submission that no double-deduction has been claimed while claiming deduction under Section 36(1)(viia), it is to be kept in mind that any claim of deduction under the Income-tax Act, 1961 shall be in accordance with the established provisions of the Act. Judicial discussions do add to the interpretations to provisions of the law but they in no manner seek the replace such provision. Hence, the judgement in the Vijaya Bank is respected but the same cannot do away with mandatory compliance with provisions of the same Section itself, i.e. first proviso to Section 36(1)(vii) and Section 36(2)(v). Thus, assessee must duly maintain provision for bad and doubtful debt in accordance with provisions of Section 36(1)(viia) and must carry out necessary accounting treatments for claim of deduction under Section 36(1)(vii) and 36(1)(viia).

f. Further, with respect to banks claim that in the preceding years, it has been allowed deduction under Section 36(1)(vii) in accordance with Vijaya Bank decision, it is stated that Principles of Res-Judicata does not apply to Income-tax proceedings.

g. The banks have been claiming deduction under Section 36(1)(vii) following Vijaya Bank case since A.Y. 2011–12. Thus, prior to this A.Y., the assessee banks made claim of deduction under Section 36(1)(vii) and 36(1)(viia) in accordance with the Act and hence, accordingly prepared provisions for bad and doubtful debts under Section 36(1)(viia). In view of the above judicial decision, it is safe to interpret that no provisions account for the purpose of Section 36(1)(viia) would have been maintained from A.Y. 2011–12 onwards. However, as there was such an account maintained for the preceding A.Y., there must still be standing a balance in that account, which is the closing balance for the F.Y. 2009–10. Thus, this position creates uncertainty with respect to future claims of the assessee bank and forebodes instability of tax regime if an assessee is allowed to whimsically switch between one claim in one year and another one in the next. The question also looms as to how a tax administrator should ensure that no double-deduction is being claimed by the assessee on account of bad and doubtful debts when there still exists a closing balance in the provisions account maintained for the purposes of Section 36(1)(viia) which is being carried forward since F.Y. 2009–10.

7. PENALTY PAID BY BANKS TO THE RESERVE BANK OF INDIA

A prominent bank paid a substantial amount as interest to the Reserve Bank of India for the irregularities committed in some of the earlier years. Though bank claimed it as an allowable expense as it was demanded by the apex bank for deficiency in the maintenance of Statutory Liquidity Ratio (SLR) on a careful perusal of the show-cause notice issued by the RBI; the Assessing Officer noticed that the assessee bank had entered into some irregular transactions in Government Securities through a broker. The assessee bank flouted directions of the Regulator and entered into deals with the brokers for entering into ready forward transactions in securities. On detailed scrutiny of correspondence with the RBI and examination of Banks' account books it was found that the amount payable to the Reserve Bank of India was not just charged as interest for compensating the routine shortfall in SLR

requirement. Shortfall in SLR was consequential only. What was of relevance was that the assessee bank acted in a collusive manner with the broker, risked public funds in transactions tainted with illegality in total defiance of guidelines issued by the Reserve Bank of India. It has been laid down by the apex court in *Madai Venkatraman & Co. Ltd. vs. CIT* (229 ITR 534) that the expenditure incurred for evading the provisions of a statute and also penalty levied for such evasion can not be allowed as a deduction. Moreover, it would be against public, the policy to allow the benefit of deduction under one statute in respect of some expenditure incurred in violation of the provision of another statute on account of any penalty imposed under that statute. The RBI's guidelines have the force of statutory provisions so far as banks are concerned. In a case where a bank makes any payment to the Reserve Bank of India, the Assessing Officer needs to minutely examine whether any such payment is made in violation of some law or in defiance of its RBI's guidelines which are mandatory in character.

8. INTEREST ON NPA/ NPI AS PER SECTION 43D R.W.S. 6EA

Normally an assessee maintaining books of accounts on mercantile basis has to show income on accrual basis. Sometimes even if the recovery of principal amount is doubtful, the interest on accrual basis has to be taxed. However, in the case of *banks provisions of Section 43D of the IT Act* allows them to offer such interest for taxation on basis. The advances (Non-Performing Assets) in respect of which banks are at liberty to offer interest on cash 'basis are specified in Rule 6EA of Income-tax Rules, 1962. Similarly the guidelines of RBI also specify the non-performing assets in respect of which the income cannot be recognized on accrual basis. The banks are computing income in respect of NPAs on the basis of RBI guidelines. However, presently the identification of NPAs on the basis of RBI guidelines is much more than the NPAs identifiable on the basis of Rule 6EA. Therefore, the claim of interest made under Section 43D will be excessive and will be required to be disallowed.

As per Rule 6EA, interest is not to be offered for taxation with respect to advances which have become non-performing for a period of 180 days or more. However, as per the guidelines of RBI, interest is not to be recognized on non-performing advances if they become non-performing for a period of 90 days or more. Generally banks do not offer interest with respect to advances which have become non-performing for a period of 90 days to 180 days as per the provisions of Rule 6EA.

The provisions of rule 6EA read with Section 43D are very clear that irregularity of the nature referred in rule 6EA (a)(ii) should be noticed for a period of 6 months or more. Thus, the benefit of non-recognition of interest in NPAs can be granted to the assessee as per the provisions of rule 6EA read with Section 43D only when the irregularities exist for a period of 6 months or more. As per the guidelines of RBI, non performing assets are recognized for default of 3 months or more. However, as per the provisions of I.T. Act and rules, the period of 3 months has not been recognized anywhere.

9. LEASED ASSETS

The issue relating to the transaction of sale and lease back of assets and other leasing transactions has been an important issue for examination in the cases of the banks and F.I.s.

10. APPLICABILITY OF SECTION 115JB/ MAT PROVISIONS

Assessee banks in some cases have claimed that the provisions of Section 115JB are not applicable to them. In this regard, an assessee bank has relied on the following:

> *"The provisions of Section 115JB are not applicable to the Bank since the Bank is not a Company under Companies Act nor a company to which the proviso to Sub-section*

2 of Section 211 of the Companies Act 1956 is applicable. However, the return is filed as per the Utility provided by the Income-tax Website wherein no space is provided for mentioning reasons for claiming non applicability of MAT."

The assessee bank can be countered using the following arguments:

1. There are no different opinions on the facts that the provisions of Section 115JB, applies to all companies as defined in Section 2(17) There is no dispute that the assessee is a company as defined in Section 2(17). It is also to be noted that Sub-Section (2) of Section 115JB is not the charging Section, its only provides the manner of computation which is to be followed by every company as defined in Section 2(17); therefore the contention of the Assessee is rejected. Moreover, plain reading of the provisions of Section 115JB clearly shows that the Section is an overriding Section and it casts duty upon every assessee which is a company, not necessarily incorporated under the Companies Act, to prepare its accounts as under any other law for the purposes of Section 115JB of the Act.

2. Also, by Finance Act 2012, Section 115JB (2)(b) and Explanation-3 have been inserted in Section 115JB to bring to tax the book profit of the companies that are mentioned in the proviso to Section 211(2) of Companies Act 1956. These companies are the insurance or banking company or company engaged in generation or supply of electricity or to any class of company for which a form of profit and loss account has been specified in or under the Act governing such class of company. Specifically, Section 115JB (2) (b) has been inserted to bring the companies covered by the proviso to Sub-section 2 of Section 211 of the Companies Act 1953 under the purview of Section 115JB. The proviso allows any insurance or banking company or company engaged in electricity generation or supply to maintain profit and loss in the form specified under the Act governing such class of company. In other words, the banking company's profit and loss account as per its governing Act *viz*, Banking Regulation Act will suffice for the purpose of computing book profit under Section 115JB. Explanation-3 provides an option to these companies to prepare accounts as per Companies Act or as per provisions governing such company.

3. In other words, post amendment to Section 115JB w.e.f. 01/04/2013 i.e., AY 2013–14 there is no ambiguity that these provisions are applicable to banking companies. This is evident from the Notes to Clauses to Finance Act, 2012 on the subject of Minimum Alternate Tax (MAT) which is reproduced below:

   i. Under the existing provisions of Section 115JB of the Act, a company is liable to pay MAT of eighteen and one half per cent of its book profit in case of tax on its total income computed under the provisions of the Act is less than MAT liability. Book profit for this purpose is computed by making certain adjustments to the profit disclosed in the profit and loss account prepared by the company in accordance with the Schedule VI of the Companies Act, 1956. As per Section 115JB, every company is required to prepare its accounts as per Schedule VI of the Companies Act, 1956. However, as per the provisions of the Companies Act, 1956, certain companies e.g. insurance, banking or electricity company are allowed to prepare their profit and loss account in accordance with the provisions specified in their regulatory Acts. In order to align the

provisions of Income-tax Act with the Companies Act, 1956, it is proposed to amend Section 115JB to provide that the companies which are not required under Section 211 of the Companies Act to prepare their profit and loss account in accordance with the Schedule VI of the Companies Act, 1956, profit and loss account prepared in accordance with the provisions of their regulatory Acts shall be taken as a basis for computing the book profit under Section 115JB.

ii. It is noted that in certain cases, the amount standing in the revaluation reserve is taken directly to general reserve on disposal of a revalued asset. Thus, the gains attributable to revaluation of the asset are not subject to MAT liability. It is, therefore, proposed to amend Section 115JB to provide that the book profit for the purpose of Section 115JB shall be increased by the amount standing in the revaluation reserve relating to the revalued asset which has been retired or disposed, if the same is not credited to the profit and loss account.

iii. It is also proposed to omit the reference of Part III of the Schedule VI of the Companies Act, 1956 from Section 115JB in view of omission of Part III in the revised Schedule VI under the Companies Act 1956.

These amendments will take effect from 1st April, 2013 and will, accordingly, apply in relation to the Assessment Year 2013–14 and subsequent assessment years.

The intention of legislature is evident from the highlighted portion of the above notes to clauses that the basis for computing book profits under Section 115JB for banking companies is the profit as computed under the Companies Act or as per the Acts governing such banking company. The said amendment is applicable for and from AY 2013–14. Further, the assesse bank is deemed to be an Indian company as per Banking Companies (Acquisition and Transfer of Undertakings), Act, 1970. In Section 11 of the said Act, the assessee bank is deemed to be an Indian Company for the purposes of Income-tax Act. The same is reproduced below:

"11. Corresponding new bank deemed to be an Indian company.

For the purposes of the Income-tax Act, 1961 (43 of 1961), every corresponding new bank shall be deemed to be an Indian company and a company in which the public are substantially interested."

It is evidently clear from the above, that assessee banks are deemed to be Indian Companies under the Income-tax Act. As per Section 2(17) of the Income-tax Act, the company means any Indian Company. Therefore, the said bank is an Indian Company and is a taxable entity for the purposes of Income-tax Act.

After insertion of Section 115JB(2)(b) of the I. T. Act, from AY 2013–14, the banking companies which are required to prepare accounts as per proviso to Section 211(2) of the Companies Act, 1956 are also covered by Section 115JB. In the proviso to Section 211(2) of the Companies Act, 1956, the banking companies are at liberty to prepare the profit and loss account in the form specified under the Act governing such companies and need not prepare the profit and loss as per Part II of Schedule VI of the Companies Act. In other words, post amendment the book profit for banking companies need not be computed as per Part II Schedule VI of the Companies Act. It can be computed as per the Act governing such banking companies and the book profit computed as such is deemed to be the profit for Section 115JB.

The assessee banks' argument that the said amendment is applicable to Banking Companies incorporated under the Companies Act and not to itself as it came into existence by virtue of Banking Companies (Acquisition and Transfer

of Undertakings), Act, 1970 and not the Companies Act. This argument is not acceptable. 'Banking company' is defined in the Companies Act as having the same meaning in the Banking Companies Act, 1949. In the Banking Companies Act 1949, banking company is defined as under.

> *"banking company" means any company which transacts the business of banking1 (in India);*
>
> *Explanation.—Any company which is engaged in the manufacture of goods or carries on any trade and which accepts deposits of money from the public merely for the purpose of financing its business as such manufacturer or trader shall not be deemed to transact the business of banking within the meaning of this Clause;"*

There is no dispute that the banking company is transacting banking business in India and is regulated by Banking Regulation Act and RBI. Therefore, the said definition squarely applies to the banking companies.

The assessee banks' argument that the provisions of the proviso to Section 211(2) of the Companies Act applies only to companies incorporated under it and not to banks can be countered as follows: Section 616 of the Companies Act extends the application of the companies Act to those companies governed by Special Acts like banks. It clearly specifies that the provisions of the Companies Act 1956 shall apply to banking companies so far as the provisions are not inconsistent with the Banking Companies Act, 1949. As discussed above, assessee banks are banking companies as per the Companies Act, 1956.

For ready reference relevant extract of Section 616 of the Companies Act is reproduced below:

> *"Application of Act to companies governed by special Acts*
>
> *616. APPLICATION OF ACT TO INSURANCE, BANKING, ELECTRICITY SUPPLY AND OTHER COMPANIES GOVERNED BY SPECIAL ACTS*
>
> *The provisions of this Act shall apply–*
>
> *a. …….*
>
> *b. to banking companies, except insofar as the said provisions are inconsistent with the provisions of the † Banking Companies Act, 1949 (10 of 1949); Page 254 of 332*
>
> *c. ……..*
>
> *d. ……*
>
> *e. ……"*

Therefore, the proviso to Section 211(2) of the Companies Act not only applies to the companies incorporated under the Companies Act but also to the banking companies governed by special Acts except when the provisions of the Companies Act are inconsistent with the Banking Companies Act, 1949. There is evidence to say that the Proviso to Section 211(2) of Companies Act is inconsistent with the Banking Companies Act, 1949. Therefore, the proviso to Section 211(2) are applicable to banking companies not incorporated by the Companies Act but are regulated by special Acts. Hence, banks are covered by Section 115JB(2)(b) of the I.T. Act.

Even after the substitution of Companies Act, 1956 with the Companies Act, 2013, the provisions of the said Act are made applicable to banking companies. In Section 4(c) of the Companies Act, 2013, the Act extends to not only to the companies incorporated under that Act but also to banking companies. For ready reference Section 4 of the Companies Act, 2013 is reproduced below:

> *"(4) The provisions of this Act shall apply to—*
>
> *a. Companies incorporated under this Act or under any previous company law.*
>
> *b. Insurance companies, except in so far as the said provisions are inconsistent with the provisions of the Insurance Act, 1938 (4 of 1938) or the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999).*

c. *Banking companies, except in so far as the said provisions are inconsistent with the provisions of the Banking Regulation Act, 1949 (10 of 1949);*

d. *Companies engaged in the generation or supply of electricity, except in so far as the said provisions are inconsistent with the provisions of the Electricity Act, 2003 (36 of 2003);*

e. *Any other company governed by any special Act for the time being in force, except in so far as the said provisions are inconsistent with the provisions of such special Act; and*

f. *Such body corporate, incorporated by any Act for the time being in force, as the Central Government may, by notification, specify in this behalf, subject to such exceptions, modifications or adaptation, as may be specified in the notification."*

There is no doubt that the provisions of Companies Act, 2013 squarely apply to banking companies. The provisions of Section 616 of Companies Act, 1956 are directly incorporated in Section 4 of Companies Act, 2013. Section 211(2) of the Companies Act, 1956 now finds place as Section 129 of Companies Act, 2013. Therefore, Section 115JB applies to a banking company which is referred in second proviso to sub Section 1 of Section 129 of the Companies Act, 2013. Therefore, Section 115JB(2)(b) is squarely applicable to banking companies even after the enactment of the Companies Act, 2013.

The assessee banks' argument also fails when the reference to 'company' in Section 115JB(2)(b) is read as a 'company' defined under the Income-tax Act and not as per the definition of 'company' in the Companies Act. The scope of the definition of 'company' as per the Income-tax Act in Section 2(17) is much wider than the Companies Act. The company as per Income-tax Act means 'any Indian Company'. It does not restrict itself to companies incorporated under the Companies Act. Therefore, when Section 115JB (2)(b) starts with "Every assesse, being a company, to which…" it refers to every company as per the Income-tax Act. The assesse is deemed to be an Indian Company and a company in which the public are substantially interested as per Section 11 of the Banking Companies (Acquisition and Transfer of Undertakings), Act, 1970.

Hence, banking companies are deemed to be companies to which Section 115JB of the Income-tax Act, 1961 is applicable.

11. DEFERRED PAYMENT GUARANTEE COMMISSION

A bank received Rs. 63,87,91,140 during the year as Guarantee Commission. It however, offered for tax a sum of Rs. 55,03,33,773 only claiming that the balance commission was received on guarantees in respect of which the period of operation of guarantee has not ended and that such commission receipts cannot be considered as income accrued during the year. Such receipts were treated by the assessee as advances in the accounts. It is a fact that the commission is always received in advance in respect of a deferred payment guarantee. In case, the guarantee is encashed, after the period, the same would in any case be a loss suffered in course of business and the assessee would debit the same to the relevant account. The commission received is like a fee for issuance of the guarantee and is not a contingent receipt or advance, returnable at the end of the guarantee period. Thus the amount of commission received is an income liable to tax as income of the year in which the bank issues the guarantee.

12. DEDUCTION CLAIMED BY CO-OPERATIVE BANKS

The income derived by the co-operative banks from their income of banking is exempt under Section 80P of the Act. But no such deduction is admissible in respect of the income from other activities like charges for lockers etc.

13. SPECIAL RESERVE—DEDUCTION UNDER SECTION 36(1) (viii)

36(1)(viii) provides for a deduction in respect of any special reserve created and maintained by a *specified entity*, an amount not exceeding twenty per cent of the profits derived from *eligible business* computed under the head "Profits and gains of business or profession" (before making any deduction under this Clause) carried to such reserve account:

The claim of the assessee bank under Section 36(1)(viii) has to be examined carefully. The various aspects are discussed later, under the heading *"Case Studies."*

14. LOSS ON FOREIGN EXCHANGE TRANSACTIONS

An assessee claimed a loss on revaluation of forward Forex contracts at the year end. It was argued that being a foreign exchange transaction such contacts are required to be assessed at the market value. In a forward contract the liability to purchase an asset arises on the date of purchase which is a future date and beyond the end of the accounting year. The actual gain or loss will depend upon the rate as prevalent on that day and the price at which the assessee purchased the asset. The difference would be an actual gain or loss to be assessed. The method followed by the assessee might be a prudent accounting principle to estimate assessees net worth but the cannons of taxation require that only real income is brought to tax. It may also happen that no loss is incurred and the transaction finally results in a profit. A loss which may or may not accrue at a future date and is based on a pure estimate is a contingent liability and cannot be allowed as a deduction under the Income-tax Act. Section 37 of the Act provides for allowance of any expenditure actually laid out or expended for the purpose of the business. Madras High Court in Indian Overseas Bank, 183 ITR 200 while examining the issue of taxability of profits arising from Forex contracts held that 'profit on contracts not yet settled amounted to notional profits which could not be taxed'.

15. DISALLOWANCE UNDER SECTION 43B

During the course of assessment it has been seen that the assessee have been claiming deduction on account of provisions for employee benefits such as leave salary, pensions, wage revision, etc. Provision for wage prevision and provision for pension have been dealt with separately. However, with respect to provision for leave salary, the assessee claim that the same is allowable as it is based on actuarial valuation in accordance with AS-15. However, provisions of Section 43B required that the same shall be allowed as deduction during the year in which such expenses as actually paid off.

16. RECOVERY IN WRITTEN OFF ACCOUNTS

It is seen that the assessee have been claiming deduction in computation of income on account of recovery in written off accounts. While such recoveries have been treated as income as per the books of the assessee, the same is claimed as deduction while computing of total income. When queried about allowability of such deduction, the assessee submitted that such the same do not pertain to write-off but pertained to provisioning of NPA. The assessee in such cases claim deduction of provision made for bad and doubtful debts under Section 36(1)(viia). Out of said provision, certain bad debts would have been written off in the books. As so written off bad debts were recovered the same partakes the character of deemed income of the year of receipt, and accordingly, chargeable to Income-tax. Therefore, argument of the assessee that no deduction were claimed under Section 36(1)(vii) would not be a material consideration in treating the same as income of the assessee.

It would be significant to mention that the very nomenclature "recoveries from bad debts written

off in earlier years" states that it was written off in earlier years.

In this context, the provisions of Section 41(4) are reproduced hereunder:

> *"(4) where a deduction has been allowed in respect of a bad debt or part of debt under the provisions of Clause (vii) of Sub-section (1) of Section 36, then, if the amount subsequently recovered on any such debt or part is greater than the difference between the debt or part of debt and the amount so allowed, the excess shall be deemed to be profits and gains of business or profession, and accordingly chargeable to Income-tax as the income of the previous year in which it is recovered whether the business or profession in respect of which the deduction has been allowed is in existence in that year or not."*

It would become crystal clear that the bad debts which were written off under Section 36(1)(vii) are to be admitted for taxation under Section 41(4) as and when recoveries are effected. The admissibility of a deduction on account of bad debts is governed by the provisions of Section 36(1)(vii) read with Section 36(2). Accordingly, the same are reproduced hereunder for ready reference:

> *36(2) In making any deduction for a bad debt or part thereof, the following provisions shall apply:*
>
> i. *No such deduction shall be allowed unless such debt or part thereof has been taken into account in computing the income of the assessee of the previous year in which the amount of such debt or part thereof is written off or of an earlier previous year, or represents money lent in the ordinary course of the business of banking or money-lending which is carried on by the assessee;*
>
> ii. *If the amount ultimately recovered on any such debt or part of debt is less than the difference between the debt or part and the amount. So deducted, the deficiency shall be deductible in the previous year in which the ultimate recovery is made;*
>
> iii. *Any such debt or part of debt may be deducted if it has already been written off as irrecoverable in the accounts of an earlier previous year (being a previous year relevant to the assessment year commencing on the 1st day of April, 1988, or any earlier assessment year), but the Assessing Officer had not allowed it to be deducted on the ground that it had not been established to have become a bad debt in that year;*
>
> iv. *Where any such debt or part of debt is written off as irrecoverable in the accounts of the precious year (being a previous year relevant to the assessment year commencing on the 1st day of April, 1988, or any earlier assessment year)and the Assessing Officer is satisfied that such debt or part became a bad debt in any earlier previous year not falling beyond a period of four previous years immediately preceding the previous year in which such debt or part is written off, the provisions of Sub-section (6) of Section 155 shall apply;*
>
> v. *Where such debt or part of debt relates to advances made by an assessee to which Clause (viia) of Sub-section (1) applies, no such deductions shall be allowed unless the assessee has debited the amount of such debt or part of debt in that previous year to the provision for bad and doubtful debts account made under that Clause.*

It will be evident from the above that the first condition for admissibility is that the relevant portion should have constituted income in the earlier years. In the instant case admittedly, such income admitted has been reversed by the provision leading to the situation that the income has not been offered for taxation and hence, the allowability of it as a bad debt itself would be in question.

In the case wherein the provisions of Section 36(1)(viia) applies it would be necessary for the assessee to debit the same to the provision for bad and doubtful debts. In the light of the above, the provisions of Section 36(1)(viia) are examined. In the case of scheduled bank, in addition to the allowance of bad debts, a provision for bad and doubtful debts is also allowed as per the provisions of Section 36(1)(viia).

A comprehensive reading of these provisions by applying the principles of harmonious construction would mandate the passing of the following journal entries in the banks:

Profit and Loss account …Dr

To Provision for bad and doubtful debts

(Being provision for bad and doubtful debts being created)

Provision for bad and doubtful debts a/c …Dr

To bad Debts account

(On bad debts being written off)

Bad Debts account …Dr

To Debtors account

(Bad debts being reduced from the debtors account)

It would be seen from the above that the bad debts written off are to be first charged to the provision for bad and doubtful debts account which has been allowed as a deduction in the books as well as in the computation of income. Thereafter, it goes to reduce the amount from sundry debtor's account which a provision does not affect. The accounting of ensuring that a scientific provision for bad debts are created and then the actual bad debts, if any, are not again charged to the profit and loss account is to ensure that there is no double charge to the profits on account of a single debt. Let us take an example of Rs. 10 lakh being charged to the provision for bad debts and subsequently a debtor of Rs. 2 lakh is to be written off, the amount of Rs. 10 lakhs has already been allowed as a deduction and the effect shall be given by setting off the bad debts against the existing provisions and not by passing another entry to reduce the profit by another Rs. **. It is only where the bad debts are in excess of the existing provision that for the deficient sum an entry is passed directly charging it to the profit and Loss account which would read as under:

Profit and loss account …….Dr

To Bad Debts account

(Being the bad debts over and above the provision charged to P&L account)

Bad Debts account …….Dr

To sundry Debtors account

(Being bad debts charged off to debtors account)

The above entries are in compliance with the accounting principles. In normal course provisions are not admissible and hence bad debts written off directly impacts the profits of the business and the recovery thereof results in income being recognised under Section 41(4). Similarly, the provisions of Section 36(2)(ii) provide for the write-off of any deficient amount and any recovery of such debt which was in excess of the provision and had been charged to the profit and loss account directly will also attract the provisions of Section 41(4).

In the event provisions are admissible deductions the same has been recognised as a loss to the business or an expense in layman's language. Accordingly, the provisions of Section 41(1) would apply which reads as under:

41(1) where an allowance or deduction has been made in the assessment for any year in respect of loss, expenditure or trading liability incurred by the assessee (hereinafter referred to as the first-mentioned person) and subsequently during any previous year,

a. *The first-mentioned person has obtained, whether in cash or in any*

other manner whatsoever, any amount in respect of such loss or expenditure or some benefit in respect of such trading liability by way of remission or cessation thereof, the amount obtained by such person or the business or profession and accordingly chargeable to Income-tax as the income of that previous year, whether the business or profession in respect of which the allowance or deduction has been made is in existence in that year or not; or

b. *The successor in business has obtained, whether in cash or in any other manner whatsoever, any amount in respect of which loss or expenditure was incurred by the first-mentioned person or some benefit in respect of the trading liability referred to in Clause (a) by way of remission or cessation thereof, the amount obtained by the successor in business or the values of benefit accuring to the successor in business shall be deemed to be profits and gains of the business or profession, and accordingly chargeable to Income-tax as the income of that previous year.*

The effect of both provisions are that where a write-off was permitted and lower taxes were remitted on this ground but subsequently, the same actually turned into a receipt, the income needs to suffer taxation.

17. PROVISION FOR PENSION

The *assessee banks have been making claim of provision for pension under Section 37(1) of the Income-tax Act.* On the basis of analysis of Section 37(1) of the Income-tax Act and settled legal principles for allowability of the expenditure under Section 37(1), such expenditure shall:

i. Not be any expenditure of the nature prescribed in Section 30 and 36.

ii. Not be in the nature of personal and capital expenditure.

iii. Only and exclusively incurred for the purpose of business or profession.

Further for an assessee maintaining accounts on accrual basis, the expenditure shall be crystallised and relate to the revenue realized during the year. In view of the above analysis, and facts of the case, the assessee's bank claims of deduction of above provision *under Section 37(1)* has not been *found to be* acceptable briefly for the following reasons:

a. Since there are specific provisions for allowing Provisional Liabilities of Pension by way of contribution of employer towards pension benefits, i.e. under Section (36)(1)(iv) and 36(1)(v) where allowability is subject to several conditions, and Section 40A(7) & (9), put several restrictions on allowances of certain expenditure relating to the benefits linked to retirement, a "provision" made for expenses of similar nature will not be allowable under Section 37(1) of the Income-tax Act by circumventing these specific provision. In fact it has been provided in the Section 37(1) itself that the expenditure allowable under this Section should not be in the nature of expenditure described in Section 30 to Section 36.

b. Further, the provisions of Section 43B will also need to be applied before allowing expenses of above nature and accordingly, the provisions will become inadmissible.

c. Without prejudice to (a) and (b), the provision otherwise not admissible under Section 37(1) of the Income-tax Act as the provision is in respect of contingent liabilities.

Since, there are specific provisions for allowing and other benefit when contribution of employer towards pension related benefits, under Section 36(1)(iv) where allowability is subject to several conditions, a provision made for expenses of similar nature will not be allowable under Section 37(1) of the Income-tax Act by circumventing

these specific provisions of the Act. To arrive at this conclusion following facts and legal position has been considered:

a. The post-employment benefit provided by the assessee bank to its employees consists of defined benefit plan and other long term employee benefits. The bank regularly contributes towards superannuation fund, gratuity fund, P.F. etc. for meeting the requirement post-employment benefits.

b. The contribution made by the assessee towards superannuation funds are allowed under Section 36(1)(iv), contribution towards approved gratuity funds are allowed under Section 36(i)(v) subject to several conditions. Further, under Section 40A(7)(a), no deduction shall be allowed in respect of any provision (whether called as such or by any other name) made by the assessee for payment of gratuity to its employees on their retirement or on termination of their employment for any reason except provision made by the assessee for the purpose of payment of a sum by way of contribution towards an approved gratuity fund, or for the purpose of payment of any gratuity that has become payable during the previous year. Section 40A also puts several restrictions on allowing several expenses incurred by an assessee as an employer except in accordance with provision of Section 36(1)(iv) and (v) of the Income-tax Act. Under these circumstances, the assessee's claim of deduction for provision for meeting the similar liabilities under Section 37(1) of the Income-tax Act is not acceptable because the Section itself bars expenses of the nature provided under Section 30 to 36 under this Section. Otherwise, such action will circumvent these specific provisions. It may be mentioned that it is a well established legal principle that special provision prevail over general provision.

c. Further, Income-tax Rules and various circulars have been prescribed by the CBDT which attach several conditions for allowability of any sum paid towards superannuation and gratuity funds. The funds are required to be approved by the CCIT or CIT. The purpose is clearly to ensure that the funds are established under irrevocable trust for the benefit of employees and to ensure that such funds should be invested in a manner which secures to them over a period of time for this purpose. Thus, ensuring the safety of the fund and prevent mis-utilization of the same has been the main purpose of various provisions under Sections. If the provision for pension is allowed under Section 37(1) of the Income-tax Act, then the entire purpose of the specific legislation will be lost.

d. In this regard, it may further be mentioned that Hon'ble Rajasthan High Court has held in the case of *Hindustan Salts Ltd. vs. CIT* (127 Taxmann 379) that since assessee had only made provision for gratuity and had no material to show that such provision was made towards an accrued gratuity fund, no deduction under Section 37 could be allowed. On the same line, the provision made for pension cannot be allowed unless the payment is made towards superannuation funds. The provision for pension will not be allowable under Section 37(1) of the Income-tax Act.

e. To support above, it is further stated that Hon'ble Bombay High Court in the case of *Forbes Campbell & Co. Ltd.* (206 ITR 494) has held that if there are two conflicting provisions then the Court should find out which of the two provisions is more general and which is more specific and construe the more general one as to exclude more specific. The principle is expressed in the 'maxim generalia, specialibus non derrogant and generaliabus specialia

derogant', i.e. if a special provision is made on a certain subject matter, that matter is excluded from the general provision.

f. Thus, the assessee's claim of above provisions which are relatable to superannuation cannot be allowed under general provisions of Section 37(1) of the Income-tax Act.

Without prejudice to arguments made so far, the provisions of Section 43B will also need to be applied before allowing above provision and accordingly, the provision will become inadmissible. In this regard, it is stated that under Section 43B(b) any sum payable by the assessee as an employer by way of contribution to any provident fund or superannuation fund or security fund or any other fund for welfare are allowed only on payment basis.

Further, the above provision is otherwise not admissible under Section 37(1) of the Income-tax Act for the following reasons:

a. It has been argued by the assessee that it was required to follow AS-15, in terms of guidelines of the RBI. Accordingly, the liability on adoption of AS-15 should be accepted by the Income-tax Department. With regard to above claim of assessee, the findings given by Hon'ble Supreme Court in the case of *M/s Southern Technologies Ltd. vs. JCIT in Civil Appeal* No. 1337/ 2003 (Jan 2010) are very relevant. In this case, the assessee which is an NBFC has created a provision for NPA, which in terms of RBI guidelines was debited to Profit & Loss Account and was claimed in the Income-tax Return. The Hon'ble Supreme Court has held that the above provision is not allowable. It has been observed by Hon'ble Supreme Court that:

"We need to emphasize that the RBI Guidelines has nothing to do with the accounting treatment or taxability of "Income" under the Income-tax Act. The two i.e. I.T. Act and the RBI Guidelines operate indifferent fields ..... Ultimately, the nature of transaction has to be examined in each case. The authority has to examine the nature of expense/ loss. Such examination and finding thereof will not depend upon presentation of expense/ loss in the financial statement. In our view, the RBI directions and IT Act operate in different eields."

b. In the same case, i.e. Southern Technologies, Hon'ble Supreme Court has also observed in respect of Real Income theory that "Income-tax is a tax on the Real Income, i.e., the profits arrived at on commercial principles subject to the provisions of the Income-tax Act. The real profit can be ascertained only by making the permissible deductions under the provisions of the Income-tax Act. There is a clear distinction between the real profits and statutory profit. The later are statutorily fixed for a specified purpose." Thus, clearly the emphasis has been given to the allowability of expenses under the Income-tax Act.

Most importantly, since there was a specific provision in Section 36(1)(vii) of the Income-tax Act relating to allowability of claim of bad debts under Income-tax Act, "the provision for bad debt" which otherwise had rightly been debited in the Profit & Loss Account in accordance with Accounting Standards and RBI Guidelines, had not been allowed under Section 37(1) of the Income-tax Act in the same case. It has been observed by Hon'ble Supreme Court that "*the provision for bad debt*", which is not allowed under Section 36(1)(vii), if claimed, has got to be added back to the total income of the assessee because the said Act brings to tax the real income, which is computed according to commercial principles, but subject to the provisions of Income-tax Act under Section 36(1)(vii), a

"write-off" is a conditions for allowance. If "real profit" is to be computed one needs to take into account the concept of "write-off" in contradistinction to the "provision for doubtful debt".

On similar lines, the provisions relating to superannuation/ retirement benefits cannot be allowed as the corresponding conditions laid down in Section 36 are not followed.

c. It is further mentioned that in the Instruction No. 17/2008 dated 26 November 2008 issued vide File No. 228/3/2008-ITA-II, the CBDT vide para (ix), it has been stated that *"Section 43 B(b) of the Act envisages that deduction towards contribution to any provident fund or superannuation fund or gratuity fund or any other fund for the welfare of employees is allowable in computing total income of the assessee only on Actual Payment Basis. Therefore, it should be verified as to whether the expenditure claimed in respect of above heads has actually been made."*

In the above case, obviously the above criteria are not met. In para (xii) of the same instruction, it has been stated that: "Section 37 of the Act *envisages that an amount debited in the Profit & Loss Account in respect of accrued or ascertained liability only in an admissible deduction, while any provision in respect of any unascertained liability or a liability which has not accrued, do not qualify for deduction. However, it has been found that Banks are claiming provisions on different accounts, probably under the RBI guidelines (e.g. Provision for wage arrears for which negotiations are yet to be finalized, provision for standard asset etc.…). A contingent liability cannot constitute deductible expenditure for the purposes of Income-tax Act. Thus, putting aside of money which may become expenditure on the happening of an event would normally not constitute an allowable expenditure under the Income-tax Act. The AOs should verify such claims as to whether these are admissible as per the Income-tax Act."*

d. Without prejudice to the discussion so far, *the above provisions represent contingent liabilities* i.e. the liabilities in respect of above provision are contingent and will crystallize only on happening of certain events such as actual superannuation or voluntary retirement of person, encashment of leave, a person reaching to the stage of getting silver jubilee award, event of resettlement, person availing LTC and HTC etc. Hon'ble Supreme Court in the case of *CIT vs. Gemini Cashew Sales Corporation* (65 ITR 643) enunciated a principle that liability contingent on the happening of certain events is not allowable.

In view of above instruction also, the above claim of assessee in respect of 'provision for pension' is not admissible.

In view of the discussion made so far the conclusion can be summarized as under:

a. In view of the language of Section 37(1) itself, it is clear that it is a residual Section for allowability of various expenses in the computation of income if there is no other specific provision relating to allowance of any expenditure under Section 30 to 36 of the IT Act.

b. Otherwise also, it is an established principle that the general provision (like Section 37(1)) will not be applicable to such an item falling within the ambit of any specific provision.

c. In the mercantile system the liability shall be an accrued liability and not a provisional liability to be allowed. Provisions of Section 36(1)(iv) and 36 1(iv) allow provisional liabilities but they are subject to certain including applicability of Section 43B of the IT Act. However, similar provisional liabilities cannot be allowed under Section 37(1) of the IT Act. In any case, the liability should be relatable to the revenue realized during the year.

In the view of the above analysis and discussions the 'provisions for pension' is a result of change in accountancy policy. The liability is dependent on other relevant events to happen and is contingent in nature. The allowance of liabilities of similar nature is actually made under specific provisions of 36(1)(iv), 36(i)(v) subject to the provisions of Section 40A(7) and (9) of the IT Act and is governed by several other conditions. Since these specific provisions are applicable for allowability of expenditure of similar nature, they cannot be allowed under general provision of Section 37(1) of the IT Act. Further, the conditions of Section 43B would also be applicable to similar liabilities. Looking to all these facts, the "provision for pension" incurred as a result of adopting revised AS-15 are not held allowable under Section 37(1) of the IT Act.

18. INCOME FROM FOREIGN BRANCHES

18.1 It has been seen that the income from foreign branches has been excluded on the basis of the DTAA Agreement entered by India with the countries where such branches are located. In support of their claims, the assessee banks make following submissions:

i. The Bank has branches in various foreign countries with which the India has entered into tax treaty for avoidance of double taxation. In terms of Article 7 of these treaties, the aforesaid branches of the Bank form a permanent establishment in the respective foreign countries. Taxes have been paid in the foreign countries on the income earned by these branches.

ii. In this connection, Article 7 of tax treaties dealing with taxability of business profits provides that if the enterprise carries on business through a PE, the profits may be taxed in the source state as that are attributable to that PE.

iii. In view of the above, the foreign branches create a PE in the foreign countries and the income from the same is taxable in the foreign countries and taxes have also been paid. Accordingly, the Bank claims that as the income has been taxed in the source state, the income from the aforesaid foreign branches is exempt in India in terms of the Article 7 of the tax treaties. In other words, Bank has not considered the income from the foreign branches while computing the total income for the purpose of taxation.

18.2 However, in view of *Section 90 of the Act* and also, in view of notification bearing *SO 2123(E) dated 28/08/2008, published in Gazette Of India on 28/08/2009*, any income of a resident of India may be taxed in other country, such income shall be included in his total income, chargeable to tax in India and relief shall be granted, for elimination of double taxation as provided in DTAA. Thus, the notification is clearly applicable and claim of the assessee to exclude business profits/ incomes of foreign/ overseas branches, from the total income for the purpose of taxation under IT Act, 1961 is not allowable and the same is to be brought to tax.

19. LOSS ON SALE OF ASSETS TO ARC

This loss pertains to loss on sale of non-performing assets to asset reconstruction companies. It has been seen during the assessment that assessee banks claim deduction on account of the above losses during the year it is incurred. However, in

terms of the RBI circular dated Feb. 26, 2014, such losses are to be amortized over a period of two years. It is seen that assessee have complied with the guideline for book purposes. However, for tax purposes entire losses have been claimed during the said year resulting in suppression of income for the year. Since, the assessee has not claimed the unamortized amount by debit to the P&L account, the same cannot be allowed as a deduction.

20. PROVISION FOR RESTRUCTURED ADVANCES, DIMINUTION IN FAIR VALUE OF ASSETS

It has been seen that banks have been claiming deduction on account of "Provision for restructured advances—Diminution in fair value of assets" while computing the total income for the purposes of Income-tax Act, 1961. It is seen from the 'notes to accounts' that the said provision has been made in pursuance to change in contractual terms upon restructuring of loan accounts. Further, the bank has submitted that the accounting treatment of such provision is based on the guidelines on the matter issues by the regulatory authority, i.e. The Reserve Bank of India. In the computation of income, it is seen that the amounting pertaining to "Provision for restructured advances-Diminution in fair value of assets" was added back by the assessee bank as the same is in the nature of provisions and contingencies. However, deduction has been claimed in the computation of income treating it as an allowable expense. From the foregoing facts, it is abundantly clear that "Provision for restructured advances-Diminution in fair value of assets" does not signify a real expense incurred during the year. Also, the same is an unascertained liability and contingent in nature. Since no such expenditure has been incurred during the relevant previous year, the same is not an allowable deduction. The claim of the assessee as stated by assessee itself is to comply with the RBI guidelines. However, reliance is placed on the decision of the apex court in Southern *Technologies Ltd. vs. Joint Commissioner of Income-tax, Coimbatore* wherein it has been held that RBI guidelines are prudential norms or disclosure norms but have nothing to do with the computation or taxability of the provisions for NPA under the IT Act. Further though the RBI Directions deviate from the accounting practice as provided in the Companies Act, they do not override the provisions of the IT Act. Further, it was held that such provisions made in terms of the RBI Directions does not constitute expense for purposes of Section 36(1)(vii). The said Provision is for presentation purposes and in that sense it is only a notional expense. Hence, the any deduction claimed by the assessee on account of "Provision for restructured advances-Diminution in fair value of assets" ought to be disallowed.

21. EMPLOYEE STOCK OPTIONS

1. Assesse banks debit amounts on account of ESOP expenses and claim the same as deduction. The assessee banks usually give the following arguments to support their claim:
   a. *That the said expenditure incurred by the Bank wholly and exclusively for the purpose of the business.*
   b. *ESOP expenses were computed as per the guidelines prescribed by the SEBI in this regard.*
   c. *ESOP expenses allowable according to CBDT Circular 9/2007.*
   d. *That the following judgements support their claim:*
      i. *CIT vs. Lemon Tree Hotels Ltd* (ITA 107/2015)–Delhi High Court–(Refer Annexure I)
      ii. *CIT vs. PVP Ventures Ltd* (2012) 23 taxmann.com 286 (Madras High Court) (Refer Annexure J)
      iii. *Caterpillar India (P.) Ltd vs. DCIT* (2017) 80 taxmann.com 325 (Chennai Tribunal) (Refer Annexure K)

However, the assessee's explanation is not tenable. The assessee quote CBDT Circular 9/2007 to support their contention. However, the CBDT, in response to Q. 16 of the circular stated as follows:

> *"In case where the employee purchases shares and then subsequently transfers the shares to its employees, the expenditure so incurred is allowable as deduction in computing the taxable income of the employer company. However, if the shares are allotted to the employees from the share capital of the company, no deduction is allowable in computing the taxable income of the company since no expenditure has been incurred by it."*

Thus, the shares of the assessee company issued to the employees and corresponding expenditure incurred by the assessee company for the same is not an allowable expenditure.

2. In some cases, the assesse banks also claim deduction on account of discount on which shares are issued to the employees. The said discount is claimed by the assessee as deduction. The same is not allowable on the following grounds:

Share premiums obtained on issue of shares are items of capital receipt. When such premium is forgone, it cannot be claimed as an 'expenditure wholly and exclusively laid out or expended for the purposes of the trade'.

There is not any specific provision for such deduction from Sections 30 to 36 of the Income-tax Act. So, the residuary Section 37 only comes to play and the primary condition for allowance under this Section is the existence of Revenue expenditure wholly and exclusively incurred for the purposes of the business. As elaborated in the above points, there is neither any real expenditure at the stage of grant or otherwise, nor the expenditure if at all any, can be qualified as Revenue in nature. The CBDT Circular No. 9/2007 dated 20/12/2007 has clearly provided that where ESOPs are purchased by the Company, and then issued to the employees then the same is allowed else it is not an expenditure.

In this regard, the decision of *Ranbaxy Laboratories Ltd vs. ACIT* (124 TTJ 771 (2009) (Delhi Tribunal) is relied upon. In giving its judgment, the Delhi Tribunal held that the issue of shares at below market price does not result into incurring any expenditure; rather it results into short receipt of share premium which the assessee was otherwise entitled to. The receipt of share premium is not taxable and hence any short receipt of such premium will only be a notional loss and not actual loss for which no liability is incurred and such notional losses are not allowable under the provisions of the Income-tax Act, 1961. Further, reference was made to Section 37 of the IT Act which requires that there should be an expenditure incurred by the assessee. However, a benefit or income foregone cannot be considered as expenditure. The Tribunal was of the view that the assesse has not incurred any expenditure but merely received lessor amount of share premium.

The above judgment has been heavily relied on in the recent judgment pronounced by Mumbai Tribunal in the case of *M/s. VIP Industries Ltd* (2010 TIOL 654). Another judgment that deserves a mention here is the case of *Lowry (Inspector of Taxes) vs. Consolidated African Selection Trust Ltd* (1940) 8 ITR (Suppl) 88 (HL) in which the House of Lords held that the difference between the market price and amount recovered from the employees cannot be allowed as deductible expenditure.

22. INTEREST PAID ON INNOVATIVE PERPETUAL DEBT INSTRUMENTS

In the assessment of the banks, the details furnished by an assessee bank during the course

of assessment proceedings, it was seen that the assessee bank had issued Innovative Perpetual Debt Instruments (IPDI) bonds which qualify as Tier I capital of Bank and book value of such bonds was on the balance sheet under the category of Tier-I capital. It was seen that the bank has paid interest at fixed rate on such bonds which was claimed as deduction on account of interest paid/ payable on these bonds under Section 36(1)(iii). In support of the claim of deduction on account of interest on these perpetual bonds, the assessee has claimed that these bonds are in the nature of debentures carrying a fixed interest rate and the interest is paid out of distributable profits of previous year or current year. The Bank has discretion to exercise the call option for the said bonds as per applicable guidelines. It was further claimed that the interest paid to the bondholders unlike dividend income is not exempt as per provisions of the Act and the bondholders would have accordingly offered the same to income in their respective returns, disallowance of the said interest would result in double taxation of the same income.

Perpetual Bonds or Debt instruments are in nature of debt instruments or bonds with no maturity date. The RBI guidelines have allowed treating the perpetual bond as tier I capital subject to certain conditions. The investors do not get the right to redeem the bonds at any given point of time. Only the issuing bank can buy back the bonds from the investors. Therefore, even if subsequently borrower buys back these bonds, it will not alter the nature and character of these bonds because it is the borrower and not the lender who has every right in such bonds to redeem it. Once the bond is sold, the rights of future interest passes to the new bond holder. To sum up the perpetual bonds are quasi equity and they have following equity like features:

a. Perpetual in nature.
b. High loss absorption capacity. Provisions for write down of principal or conversion to equity on trigger.
c. Discretionary pay-out with existence of full coupon discretion.

As per the provisions of Section 36(1)(iii), deduction is allowed in respect of the amount of interest in respect of capital borrowed for the business and profession. However, reference may be made to the decision of the Hon'ble Punjab & Haryana High Court in the case of *Pepsu Road Transport Corpn vs. CIT, Reported in* 130 ITR 18 (P&H), that an element of refund or repayment is a must in the concept of borrowing. If there is no obligation to refund the capital provided, interest on such capital is not deductible under Section 36(1)(iii). Therefore, in case of perpetual bonds, where the lender does not have authority to claim refund of the amount given, the said amount cannot be held as 'borrowing and hence the interest on such bonds is not admissible as deduction under Section 36(1)(iii).

23. BAD DEBTS CLAIM ON CREDIT CARD BUSINESS UNDER SECTION 36(1)(vii)

The assessee banks claim bad debts under Section 36(1)(vii) of the Act on account of bad debts incurred during the course of credit card business. Whether such a claim is to be allowed or not, is discussed using an illustrative description in the heading, *"Case Studies."*

24. LOSS ON REVALUATION OF SECURITIES

The deduction claim of assessee banks on loss on account of revaluation of securities and the allowability of the same is a pertinent issue and is discussed in the heading, *"Case Studies."*

25. PROVISION FOR FOREIGN TAXES

An assessee being a resident of India, is assessed to tax on is global income. In a case it was found

that the assessee made a provision for payment of Income-tax in respect of the taxes payable by its branches overseas treated as permanent establishments in the respective countries. Relying on the decision of the Hon'ble Bombay High Court in Ambalal Kilachand (210 ITR 844) it was claimed that it is the net foreign income after deduction of foreign tax which is taxable in India. In this case, dividend income was received by a person who was not resident of the United Kingdom. The tax which was deducted on the dividends in UK, could be taken credit of by the individual in the UK, since the individual did not file tax return in that country. The court, therefore, held that 'what accrues to the individual in respect of shares held by him in UK is the dividend actually received by him ad that the amount initially available for distribution cannot be considered as income accruing to the assessee of the reason that the assessee does not have any right to receive such amount'. He also does not have any right to claim any credit for tax which is deducted on that amount. The decision of Bombay High Court is clearly on a different footing from the cases of the banks and F.Is. which are resident in India. In the case of a bank, the foreign branches pay tax in respect of their income in the foreign country. This income is included in the world income of the assessee and credit for foreign taxes paid can be taken by the assessee bank to the extent available under the Double Taxation Agreement. In addition to the above, a provision for taxes would not, even otherwise, be allowed as a deduction in the computation of total income of the assessee.

26. INTEREST ON REFUNDS ISSUED UNDER THE INCOME-TAX ACT

During the course of assessment for certain assessee banks, it was seen that the banks were offering interest under Section 244A on refunds received as income from business after adjusting the same against interests paid to the income department under various Section such as 234B, 234C, etc. The allowability of the same is a pertinent issue and is discussed in the heading, *"Case Studies."*

27. ISSUES IN FOREIGN BANKS HAVING BRANCHES IN INDIA

27.1 Head Office Expenses

Section 44C of the Act lays down the nature and extent of the expenses incurred by the H.O. of a non resident assessee. It also specifies the mode of computation of admissible deduction under that Section. Thus normally only a part of the H.O. expenses will be allowable as a deduction. There is obviously an attempt on the part of same banks to classify part of their Head Office expenses as expenditure under other heads to escape the limitations placed on the allowance of H.O. expenses by the provisions of Section 44C. The single most important issue to be decided in such cases is whether any expenditure in the nature of head office expenses is debited under any other head of expenditure or otherwise claimed in the return. It requires detailed examination of accounts and investigation into the real nature or the expenses debited under other heads. Some of the common items of expenses normally to be shown as H.O. expenses but not classified by the assessee banks as H.O. expenses are:

27.1.1 NRI Deposit Mobilisation Expenses

In a number of cases, assessee banks claimed deduction on account of expenses on salaries, travelling and other incidental expenses for mobilisation of deposits abroad from nonresident Indians incurred by the head office of the bank. During the course of assessment proceedings it was claimed that the Indian Operations Liaison Office incurred certain expenditure for the purpose of mobilising deposits from NRIs in the Middle East countries using network of the bank. This expenditure was borne for the Head Office but had been incurred wholly for the purpose of the banks' Indian operations and, therefore, the same was claimed to allowable as a deduction.

However, this very issue has been decided in the case of American Express Bank for A.Y. 89–90 by the ITAT Mumbai bench wherein it was held that on the given facts 'the expenditure, as aforesaid, has to be considered as head office expense and is to be considered for deduction under the provisions of Section 44C alone and that such expenditure is not allowable under any other Section from Sections 28 to 37'.

27.1.2 Salaries to Expatriate Employees

In a number of cases of the banks and F.I.I.s, it was found that some employees stationed abroad visited India for short duration and payments made to them for the period when they worked in India were not commensurate with the corresponding emoluments that would be paid to executives in India. It was claimed that the expatriate-employees posted in India were entitled to the emoluments that they were paid abroad, as per the policy of the group and as such these payments were allowable as deduction in computation of income of the assessee. It was further claimed that the expatriate employees on short posting away from their home country have to maintain some establishment abroad for which they are paid part of the emoluments in the foreign country. It was seen from the return of income that the Head Office of assessee bore the expenditure on the emoluments paid abroad possibly because the entire burden could be loaded to the Permanent Establishment (PE) India. This expenditure was not debited to the accounts of the Indian establishment of the bank. The employees were basically employed by the Head Office and temporarily posted to the Indian branch. A portion of the salary was paid in India by the branch whereas another portion was paid by the H.O. being the original employer abroad. This part of expatriate salary was as such relatable more to the group policy of maintaining a top level team which could be employed in any of the bank offices, world wide. The entire payment, Therefore, was not a direct payment for the services rendered by the expatriate employees in India. It is possibly for this reason that it was decided not to debit the entire emoluments to the books of the Permanent Establishment in India. Head office expenditure is defined under Section 44C as general or executive expenditure incurred by the assessee outside India. If an assessee has incurred the expenditure outside India and the expenditure is of a general administrative nature, it is within the ambit of Section 44C of the Act. In a number of cases it has been found that the expenditure of the nature, as aforesaid, was booked under the head 'salaried paid' in the HO accounts. The amount is determined and paid by the HO and claimed as a deduction by the HO from its total income. It is also not debited subsequently to the Indian Branch. There is thus no difference between this expense and other allocable expenses under Section 44C. The so called direct expenses may, thus, be part of the general expenses of the HO which are eligible for allocation and deduction under Section 44C.

27.1.3 Expenditure on Group Credit Risk Management

The expenditure on account of Group Credit Risk Management is essentially a H.O. function and therefore allocable under Section 44C of the Act. In respect of expenses, as aforesaid, foreign banks often advance an argument that under the DTAA with the respective to contracting states, all expenses incurred for purposes of business are fully allowable. The relevant articles in the DTAAs are by and large borrowed from the UN Model convention which lays down that legitimate business expenditure should not be disallowed by the contracting state due to some peculiarity of the local laws. The articles in UN Model convention are taken with certain changes from the OECD convention. The basic aim of this article is to ensure taxation of profits attributable to a PE which would be earned by it if it were a wholly independent entity dealing with its head office as if it were a separate entity operating under conditions and selling at prices

prevailing in the regular market. It is further stated that the rule permits the authorities to make adjustments to the accounts of enterprise if necessary to arrive at the profits if it was an independent enterprise. This article ensures that legitimate business expenditure should be allowed for arriving at the profits of the permanent establishment in a uniform manner by all the member countries. The Indian Income-tax Act allows legitimate business expenditure while working out the taxable income, though, some limits have been prescribed with respect to certain types of expenditure in consonance with the economic and social objects of the Govt. policy besides propagating sound and healthy business practices. To say that the relevant article in the DTAA prescribes that no limit be applied in respect of any legitimate business expenditure is to stretch the interpretation of the article beyond its intention. In fact, every country, prescribes some artificial restriction of this kind. If the assessee's interpretation is to be followed, it could mean different treatment to nonresident companies *vis-a-vis* resident companies doing similar business which would certainly amount to discrimination. In this connection it is pertinent to reproduce from an important decision of Calcutta Bench ITAT in the case of Bank of Tokyo-Mitsubishi LTD.

'Article 23(1) of DTAA provides that the laws in force in either of space shall continue to govern into respective states except where express provisions to the contrary are made in the convention. The differential tax rates were in existence ate the time of signing of the treaty and therefore, the same shall continue to govern the taxation of income in India except where express provisions to the contrary have been made in the DTAA itself. The provisions of Article 24(2) cannot be pressed into service in relation to such provision of the Income-tax Act, which existed at the time of signing of the convention. In this view of the matter the provisions of Article 24(2) would appear to be intended to safeguard against the laws of either contracting state being subsequently amended to the detriment of the enterprises or the other contracting states.

There is no dispute that a deduction for head office expenditure should be allowed to the permanent establishment albeit within the limits specified under the Income-tax Act. The commentary on the UN Model convention mentions that the Clause relating to allowance of expenditure relating to business would not preclude the contracting State where the PE is located from making certain adjustments to the accounts of PE in order to ensure that the correct profits are brought to tax. This implies that the limits of expenditure prescribed in various Sections are applicable in such cases and that the same are not in conflict with the relevant articles of the DTAAs. In view of the above, the disallowances are required to be made in accordance with the provisions of Section 44C of the Act.

27.1.4 Interest Received from Head Office/ Foreign Branches

The banks and FIIs are found to have deducted the amount of interest received from their branches overseas and the interest on NOSTRO account from their income. The amount of interest received from the branches overseas is deducted on the ground that it is a receipt from self and, therefore, it cannot be construed as the income. As regards, the deduction of interest on Nostro balances, it was claimed in one of the case that:

'Our clients' Head Office at Paris and the entire branch network maintain a US dollar account (the NOSTRO account) with the Bankers Trust company, New York (BTC). The balance to the credit of this account is available as US dollar float to our clients to be drawn upon as and when required. The NOSTRO account is made up of the transactions of our clients' entire network in the US dollar accounts, insofar as the India branch is concerned, a major part of the account comprises of amounts credited in respect of

funds received through FCNRB Deposits from clientele abroad in foreign currency. As the forward cover costs prevailing at the time are high the Mumbai branch decided not to convert these into local currency but leave them in the US Dollar NOSTRO account overseas till such time that it was economically feasible to convert the funds into rupees for local lending. BTC pays interest on the credit balances at a rate which is 2% less than the federal funds rate. BTC sends a statement of the interest payable by it on such account directly to the Bombay Branch. However, our clients, for their internal accounting purposes treat such interest as received through its head office for credit to the Mumbai branch. It is submitted that Section 4 of the Act provides that Income-tax shall be charged fro every year in respect of the total income of the previous year of every person. Section 5 defines the scope of total income. Section 5(2) provides that the total income of any previous year of a person who is a non-resident includes all income from whatever sources derived which (a) is received or is deemed to be received in India in such year by or on behalf of such person; or (b) accrues or arises or is deemed to accrue or arise to him in India during such year. Interest from BTC is neither received nor could it be deemed to have been received in India by our clients. Such interest also does not accrue or arise to our clients in India.'

It was seen that the NOSTRO account of the Indian branch of the bank comprises of mainly funds received through FCNR deposits. The foreign currency was kept with BTC temporarily due to the reason that the dollar price was fluctuating during that time and the bank did not find it economically feasible to convert the funds into Rupees for local lending. It was clear from this that the funds received from NRIs were kept as deposits and interest was earned from the same and at the same time, interest on FCNR deposits have been paid to the depositors by the bank and claimed as deduction in computing its income. The deposits obtained by the bank are the assessee's regular business. It was found that the assessee maintained an infrastructure in some Middle East countries mainly to mobilise deposits from the NRIs. Thus the funds coming through FCNR (B) deposits arose from the business carried on in India. The funds meant for deployment in the Indian business had been parked in the BTC temporarily as the assessee found it imprudent to bring the funds and deploy the same in India. Interest in question was received mainly from these funds. A perusal of the balance sheet showed that the entire deposits/ borrowings of the Indian branch is from within India, The borrowings out side India was Nil. The money at call abroad has thus been deployed out of funds borrowed in India. As per the audited accounts of the assessee the interest was shown as received on NOSTRO account balances of Indian branch with the Head Office. The deposits received were the property of the Indian Branch. The income from this property was therefore taxable under Section 9(1)(i) of the Act. What is assessable in India is the profits attributable to the Indian branch. According to the Indo-French treaty, the profits attributable to the PE in India will be taxed in India. The purpose is to arrive at the income of the Indian operations deeming the Indian operation or branch as an independent entity. Therefore, interest income on NOSTRO balances cannot be excluded.

27.2 Rate of Tax

In a case the assessee bank had claimed that the tax rate as applicable to Indian companies carrying on similar business should be applied in its case instead of the rate applicable to non-resident companies. The issues raised by the assessee was the subject matter of an appeal before the ITAT, Calcutta in Bank of Tokyo-Mitsubishi Ltd. decided on 31/3/1997. The applicant had questioned the tax rates for nonresidents *vis-a-vis* the provisions of

Article 24(1) of the treaty with Japan regarding nondiscrimination. The Tribunal rejected the appeal of the assessee holding that there is no discrimination and held that the rate of tax provided under the Act would apply.

27.3 Interest Paid to HO

The assessee deducts TDS and claims the interest paid to HO as an expense. However the HO does not offer the same as income.

The interest paid to HO is treated as income in the hands of the HO under the TAA.

27.4 Fees Received from Overseas Branches

The assessee claims benefit of Article 7 of the DTAA and does not offer the same to tax.

The benefit of article 7(7) is denied to the assessee since the amount received are either in nature of marketing fees and guarantee fees. Income is brought to tax as business income of the PE/ BO.

27.5 Refurbishment Expenses

Refurbishment of rented premises are claimed as revenue expenses.

The refurbishment expense is not allowed to be an item of revenue. AO treats it as a capital expense.

Depreciation is allowed.

27.6 Interest in Suspense Account Charged to Tax Denying the Benefit of Section 43D

The interest earned on NPA accounts is not offered to tax by the assessee taking advantage of the general or residuary Clause of Rule 6EA.

a. Benefit of Rule 6EA is denied since the assessee its case was covered in the specificclauses of Rule 6EA and it did not satisfy the conditions laid down in specific clauses.

27.7 Data Processing Charges Paid to HO/ Regional Centre

It is treated as FTS/ Royalty as per the facts of the case & applicable DTAA.

27.8 Transfer Pricing Adjustments

i. **Share of Profit in Relation to ECBs and other Products:** TPO makes an adjustment to the income earned by the assessee from rendering services to the HO for selling of derivatives and other products. Whereas the assessee offers the income @ 20% of the net interest income earned by the HO from such transactions, the TPO enhances the same to 50% as ALP.

ii. **Royalty Paid on Brand:** The ALP of the price of royalty paid by the branch is reduced to ZERO.

iii. **Direct Costs Attributable to India branch and Head Office Expenses:** Same as discussed earlier.

SOURCES OF INFORMATION FOR ASSESSMENT OF BANKS

1. Reserve Bank of India

a. The best source of information available to the AO in assessment of banks is the quarterly returns banks file with the Reserve Bank of India. Thus, a by-quarter bifurcation of the bank's financials (Balance Sheet, P&L and other statements) are readily available to the Assessing Officer.

b. The RBI also regularly audits the books of account of banks. The AO can access such audit reports of the RBI to effectively understand the financial position of the banks.

c. The *guidelines issued by the Reserve Bank of India* affect everyday working and liquidity position of the banks. The guidelines may also be used as source for misinformation to the Assessing Officer. Hence, the AO must be cautious and

cross examine the applicability of such guidelines to income recognition under the Income-tax Act:

i. Guidelines for provisions to be made on various classes of assets (Standard assets, substandard assets, Doubtful assets etc. This is relevant in the calculation of allowable provision under Section 36(1)(viia) of the Act. It is important to note that the provision made for standard assets as per RBI guidelines is NOT included in the provision for bad and doubtful debts under Section 36(1)(viia) of the Act.

ii. Guidelines for calculation of interest income on Non Performing Assets: Assessee banks follow RBI guidelines recognize income from NPAs on receipt basis and not on accrual basis, for the purpose of Income-tax assessment, interest income on all types of advances shall be recognized on accrual basis only.

2. Information from SEBI

In recent times, to tackle the menace of NPAs and loan default, the RBI and SEBI have directed listed banks to disclose any divergence exceeding 15% in the provisioning and asset classification. As per the SEBI circular, listed *banks* are required to comply with the following:

1. Disclose to the stock exchanges divergences in the asset classification and provisioning wherever the additional provisioning requirements assessed by the RBI exceed 15 per cent of the published net profits after tax for the reference period; and/ or the additional gross NPAs identified by the RBI exceed 15 per cent of the published incremental gross NPAs for the reference period;
2. Place the disclosure (in the format specified in the Annex to the aforesaid RBI's notification) as an annexure to the annual financial results filed with the stock exchanges in accordance with Clause (d) of sub-regulation (3) of Regulation 33 of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015;
3. Disclosure shall be made along with the annual financial results filed immediately following communication of such divergence by RBI to the bank.

The above disclosure norms can also be vital information sources for the Assessing Officer.

2.1. Disclosure to Stock Exchanges

Listed Banks have to comply with various disclosure norms of the Stock Exchanges they are registered in. This is a vital source of information for the Assessing Officer for stock price movement, *related party transactions (of directors, promoters of the bank)*, share price movement in the case of amalgamation or demerger, etc.

2.2 Claims Made with NCLT

After the introduction of the Bankruptcy and Insolvency Code of 2016, (BIC), there has been an upsurge in the number of companies filing for bankruptcy before the National Company Law Tribunal. Banks, who have been burdened by NPAs in the form of loans given to such companies have also appeared before the NCLT with their claims in the capacity of creditors. The AO can get vital information from the NCLT for claims that have been successfully rewarded to banks, and explore the possibility of application of Section 41(4) to the same.

2.3 Census Data

A vital source of information to assess whether a branch is a rural branch or not of a bank (for the purpose of calculation of permissible deduction under Section 36(1)(viia) or otherwise) is census data. The bank may be asked to reconcile the data shown for rural branches according to the latest available census data, to determine whether or not the branch may be classified as a rural branch or not.

BANKING LEGISLATION IN INDIA

Important legislation which govern banking business in our country are as follows:

1. The Negotiable Instruments Act, 1988

The Act is applicable to negotiable instruments i.e. Promissory notes, bills of exchange and cheques. These instruments are used to a large extent in the modern banking work.

2. The Reserve Bank of India Act, 1934

The Act governs the working of the Reserve Bank of India which is the Central Bank of the country. It has to operate the 'the currency and credit system of the country to its advantage' and also administer the provisions of Banking Regulation Act, 1949. The bank is vested with supervisory authority and power to enforce monetary discipline on all banks (including nationalised banks). It has to ensure that the affairs of all banks are conducted in a manner not detrimental to the interest of the depositors and in a manner conducive to public interest.

3. The Banking Regulation Act, 1949

The Act has been framed with the objective of regulating banking business in our country. Prior to the enactment of this Act banking companies were governed by the provisions contained in part X-A of the Indian Companies Act, 1913. But these provisions proved to the inadequate in regulating the rapidly growing business of banking institutions and hence a separate Act was passed.

In accordance with the provisions of the Banking Act, a banking company may engage only in specified business activities, including, inter alia:

i. Borrowing or lending of money with or without security; the guarantee and indemnity business;

ii. Drawing and dealing in bills of exchange, promissory notes, warrants, debentures and other instruments/ securities.

iii. Granting/ issuing currency, traveller's cheques, letters of credit.

iv. Buying and selling foreign exchange.

v. Providing safe deposit vaults; the collecting and transmitting of and securities.

vi. Underwriting, participating and managing of any issue (public or, private) of any loans or of shares, stock, debentures, or debenture stock and lending money for such purpose.

vii. Undertaking and executing trusts; undertaking the administration of estates as executor, trustee or otherwise.

viii. Acquiring the whole or any part of the business (if specified under the Banking Act) of any person or company.

ix. Any other business which the government may specify from time to which.

However, the Banking Act also places restrictions on activities of banks, which inter alia, cannot undertake the following:

i. Dealing in the buying or selling or bartering of goods, except for realisation of security and (ii) engaging in any trade or buying, selling or bartering of goods for others (except for bills of exchange received for collection or negotiation);

ii. Holding immovable property, except for as required for their own use, for period exceeding seven

iii. From acquisition of such property (and must be disposed of within such period or any other prescribed period).

iv. Holding shares in any company, whether as pledgee, mortgagee or absolute owner, in an amount exceeding 30% of the paid-up share capital of that company or 30% of its own paid-up share capital and reserves (whichever is less);

v. Providing loans to any company for buy-back of its own securities; and

vi. Acting as managing agent or secretary or treasurer of a company.

4. The State Bank of India Act, 1955

The Act governs the State Bank of India. There is a separate Act for governing its seven subsidiaries. Vide notification in the Gazette of India No. 128 dated 22/02/2017, the government has notified that the following 5 associate banks have been acquired by the State Bank of India w.e.f. 01/04/2017:

i. State Bank of Bikaner and Jaipur
ii. State Bank of Hyderabad
iii. State Bank of Mysore
iv. State Bank of Patiala
v. State Bank of Travancore

The other associate banks, *viz.* State Bank of Saurashtra and State Bank of Indore were acquired by State Bank of India on 13/08/2008 and 26/08/2010 respectively.

5. The Companies Act, 2013

Though a separate Act for regulation of banking companies has been enacted, the general provisions of the Companies Act are still applicable to banking companies because the provisions of the Act are in addition to and not in derogation of (except when expressly provided) the provisions of the Companies Act, 2013. In Section 1(4)(a), the Companies Act 2013 very clearly specifies that *"banking companies, except in so far as the said provisions are inconsistent with the provisions of the Banking Regulation Act, 1949 (10 of 1949)".*

The old Companies Act, 1956 continues to apply for years prior to coming into effect of the new Act.

6. The Banking Companies Act, 1949

This Act provides for a law to consolidate and amend the law relating to banking companies.

7. The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970

The Act has setup 'new banks' by nationalising 14 'old banks' as given in the Act.

8. The Regional Rural Bank Act, 1976

The Act has been enacted for incorporation and regulation of the Regional Rural Banks. It has come into effect from 26th September, 1976.

9. The Banking Companies (Acquisition and Transfer of Undertaking) Act, 1980

The Act has come into effect from April 15,1980. The Act has setup six "new banks' by nationalising six existing banks as given in the Act.

Besides, the above Acts, the Interest Tax Act, 1974, the Indian Contract Act, the Indian stamp Act, the Banker's Books Evidence Act, etc. also regulate the banking business. Two main acts that govern and regulate banking business are (i) The Banking Regulation Act and (ii) The Negotiable Instruments Act.

10. The Payment and Settlements Act, 2007

The Payment and Settlement Systems Act, 2007 and the Payment and Settlement Systems Regulations, 2008 framed thereunder, provide the necessary statutory backing to the Reserve Bank of India for undertaking the Oversight function over the payment and settlement systems in the country. Subject to certain conditions, any entity operating a payment system is required to obtain an authorization from the RBI, which is the nodal authority for payment systems. The government of India had proposed setting up of Payment Regulatory Board in the RBI to initiate certain structural reforms in the regulatory framework as part of Budget 2017.

11. Circulars and Notifications by RBI

The operations of banks are also monitored and governed by the instructions of RBI through various criculars/ notifications from time to time. On a (roughly) annual basis, the RBI consolidates these by topic as "Master Circulars" or "Master Directions" (e.g. in relation to know-your-customer (KYC) norms, prudential norms for NBFCs, external commercial borrowings, etc)

12. Regulatory Frameworks and Compliances

The legal and institutional framework for bank supervision in India is provided under the Banking Regulation Act, 1949. Until 1994, different departments in Reserve Bank of India were exercising supervision over banks, non-banking financial companies and financial institutions. To keep a close watch on financial markets and avoid recurrence of crisis in the financial system, the Board for Financial Supervision was setup under the aegis Reserve Bank under Reserve Bank of India (Board for Financial Supervision) Regulations, 1994 with the objective of paying undivided attention to the supervision of the institutions in the financial sector.

To have better supervision and control, a separate board was constituted namely "The Board for Financial Supervision" as per the provisions of the RBI. The Board has the jurisdiction over the banking companies, nationalized banks, State Bank of India and its subsidiaries. The members of the Board are: Governor of the Reserve Bank of India as the chairperson, Deputy Governors of the Reserve Bank of India, and one of the deputy governors should be nominated by the Governor as the full time vice chairman, four directors from the Central Board of the Reserve Bank nominated by the Governor as members.

The balance sheet and the profit and loss account of a banking company have to be audited as stipulated under Section 30 of the Banking Regulation Act, 1949. Every banking company's account needs to be verified and certified by the Statutory Auditors as per the provisions of legal frame work. The powers, functions and duties of the auditors and other terms and conditions as applicable to auditors under the provisions of the Companies Act are applicable to auditors of the banking companies as well. The audit of banking companies books of accounts calls for additional details and certificates to be provided by the auditors.

The RBI collects various fixed format data (called 'Returns') from commercial banks, financial institutions, authorized dealers and non-banking financial institutions. Many of these returns are statutory under the Reserve Bank of India 1934, Banking Regulation Act 1949, Foreign Exchange Management Act 1999, etc. Submission frequency of these returns varies from daily, weekly, fortnightly, monthly, quarterly, half-yearly and annual.

The conventional methods of returns submission follow traditional and non-web based modes of communication, *viz.*, hard copies sent through postal service, faxes and PDF files sent through e-mails. All these modes of filing returns have their own limitations. Hence a need was felt for developing a single electronic returns submission window–thus came the Online Return Filing System (ORFS).

As a part of the online filing of returns, the Reserve bank of India felt the need for the adoption of the best international technology solution. Thus Reserve Bank of India adopted eXtensible Business Reporting Language (XBRL), which attempts the standardisation of business reporting, especially financial reporting. While ORFS brings no standardisation across the returns, XBRL is capable of implementing global standards across all returns. The effort is towards building a taxonomy for the entire financial sector, irrespective of the financial segments.

Online Returns Filing System (ORFS) is a single window returns submission system which harnesses the power of internet. Incorporating any change in the return template requires modification of the application software hosted centrally and is accessible using web technology. Thus, there is no requirement for re-distributing any software to the banks. Initially, ORFS was developed for one of the most important returns, Form A return, submitted by banks as per Section 42(2) of the Reserve Bank of India Act 1934. This is a fortnightly return, submitted by banks on 'Reporting Fridays'. The system slowly expanded to other returns. Currently, there are 27 returns under ORFS.

Under ORFS, commercial banks enter data or upload the return online through the web based front-end, access of which is given to banks through a user based access policy. The returns submitted by banks first reach a central data pool, which is then pushed to the respective user departments in the Reserve Bank. ORFS recognises the power of eXtensible Markup Language (XML), which is the basic communication format between the front-end and the central data pool, and, between the central data pool and the computer systems used by user departments within the Reserve Bank.

EFFECT OF IND AS AND ICDS ON TAXATION OF BANKS 46

A. Relevant Accounting Standards (Ind AS)

The accounting for interest income differs in many ways under Ind AS compared to the existing Indian GAAP. The effect of IndAS would be mainly in the following areas in the case of banks and other financial institutions:

1. Effective Interest Rate

Under the existing Indian GAAP, loan-processing fees are recognized upfront in the profit and loss account and costs relating to origination of loans are debited to the profit and loss account.

Under Ind AS, these fees will be amortized over the life of the loan using the "effective interest rate" method. Effective interest rate is the rate that discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortized cost of a financial liability. When calculating the effective interest rate, an entity should estimate the expected cash flows by considering all the contractual terms of the financial instrument (e.g., prepayment, extension, call and similar options). The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

Under Indian GAAP, service charges, fees and commission income are generally recognized on due basis. However, under Ind AS, fees that are an integral part of the effective interest rate of a financial instrument are treated as an adjustment to the effective interest rate, unless the financial instrument is measured at fair value, with the change in fair value being recognized in profit or loss. In those cases, the fees are recognized as revenue or expense when the instrument is initially recognized.

Fees that are an integral part of the effective interest rate of a financial instrument include:

i. Origination fees received on the creation or acquisition of a financial asset;

ii. Commitment fees received to originate a loan when the loan commitment is not measured at fair value through profit or loss and it is probable that the entity will enter into a specific lending arrangement;

iii. Origination fees paid on issuing financial liabilities measured at amortized cost.

iv. Fees that are not an integral part of the effective interest rate of a financial instrument:

v. Fees charged for a specific service;

vi. Commitment fees to originate a loan when the loan commitment is not measured at FVTPL and it is unlikely that a specific lending arrangement will be entered into;

vii. Loan syndication fees received to arrange a loan and the entity does not retain part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants).

2. Interest Income on Non-Performing Assets

The RBI guidelines require interest income on nonperforming assets (NPAs) to be recognized on realization basis only. Under Ind AS 109, interest income is generally recognized on effective interest rate on the gross carrying amount of

financial assets depending on the stage in which the loan is. In the case where the loan or an asset is considered impaired, the interest income will be accounted for at the net amount, i.e., gross carrying amount less provisions made.

3. Relevant Date for Recognition of Gains/ Losses on Dealing with Securities

Under Indian GAAP, the RBI requires gains and losses on the sale of Government securities to be recognized on the settlement date.

Ind AS 109 allows a company to recognize gains and losses on dealing with securities on either the trade date or the settlement date. However, this policy has to be consistently applied for each category of financial assets: amortized cost, FVOCI, FVTPL, designated at FVTPL and equity instruments designated as FVOCI. Therefore, trade date or settlement date accounting is required to be adopted at a higher level than at the level of a type of security, i.e., government securities.

4. Accounting for Customer Loyalty Programs

Under Indian GAAP, a bank does not separately account for income from customer loyalty programs. The bank provides for liability toward these reward points by estimating the probability of redemption of customer loyalty reward points using an actuarial method by employing an independent actuary and based on certain assumptions.

Under Ind AS, award credits under customer loyalty programs are accounted for as a separately identifiable component of the transaction in which they are granted. The fair value of the consideration received in respect of the initial sale is allocated between the award credits and the other components of the sale. Income generated from customer loyalty programs is recognized as "other operating income."

5. Sale of NPAs

The extant RBI guidelines provide for the deferment of recognition of gains/ losses (sale to reconstruction companies (RCs) or securitization companies (SC)) as well as the non-recognition of gains (where sales are made to non RCs/ SCs).

The accounting treatment for such sales would be governed by the de-recognition criteria specified under IND AS 109. If the criteria for de-recognition is met then, the gains would be recognized upfront.

6. Income-tax

1. AS 22 Accounting for Taxes on Income is based on the income statement liability method, which focuses on timing differences. Ind AS 12 Income-taxes is based on the balance sheet method, which focuses on temporary differences. One example of the temporary *vs.* timing difference approach is revaluation of fixed assets. Under Indian GAAP, no deferred tax is recognized on upward revaluation of fixed assets where such revaluation is credited directly to the revaluation reserve. Under Ind AS, companies will recognize deferred tax on revaluation component if the other recognition criteria are met.
2. Ind AS 12 requires the recognition of deferred taxes in case of business combinations. Under Ind AS, the cost of a business combination is allocated to the identifiable assets acquired and liabilities assumed by reference to their fair values. However, if no equivalent adjustment is allowed for tax purposes, it would give rise to a temporary difference. Under Indian GAAP, business combinations (other than amalgamation) will not give rise to such deferred tax adjustment.
3. Where an entity has a history of tax losses, the entity recognizes a deferred tax asset arising from unused tax losses or tax credits only to the extent that it has sufficient taxable temporary differences, or there is other convincing evidence that sufficient taxable profit will be available under Ind AS. Under Indian GAAP, if the

entity has carried forward tax losses or unabsorbed depreciation, all deferred tax assets are recognized only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realized. Ind AS 12 does not lay down any requirement for consideration of virtual certainty in such cases.

4. Under Ind AS, an entity should recognize a deferred tax liability in consolidated financial statements for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures—e.g., undistributed profits—except to the extent that the parent, investor or venturer is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future. Under Indian GAAP, deferred tax is not recognized on such differences.

5. Under Ind AS, deferred taxes are recognized on temporary differences that arise from the elimination of profits and losses resulting from intra-group transactions. Deferred tax is not recognized on such eliminations under Indian GAAP. The deferred taxes in the CFS are a simple aggregation of the deferred tax recognized by various group entities.

6. Disclosure required for income taxes is likely to increase significantly on transition to Ind AS. The following are examples of certain critical disclosures mandated in Ind AS: an explanation of the relationship between tax expense (income) and accounting profit; an explanation of changes in the applicable tax rate(s) compared to the previous accounting period; and the amount (and expiry date, if any) of deductible temporary differences, unused tax losses, and unused tax credits for which no deferred tax asset is recognized in the statement of financial position.

7. Classification as Debt or Equity

Ind AS 32 requires the issuer of a financial instrument to classify the instrument as liability or equity on initial recognition, in accordance with its substance and the definitions of the terms. The application of this principle may require certain instruments that have the form of equity to be classified as liability. For example, under Ind AS 32, mandatorily redeemable preference shares on which a fixed dividend is payable are treated as a liability. Under extant Indian GAAP, classification is normally based on form rather than substance. In the context of banking in India, there could be an impact in terms of classification for certain quasi equity and subordinated debt type instruments such as perpetual debt instruments (PDI) and perpetual non-cumulative preference shares (PNCPS) issued as a part of tier I or tier II capital.

Ind AS 32 sets out the requirements regarding the offset of financial assets and financial liabilities in the balance sheet. The requirements include:

i. A currently legally enforceable unconditional right to settle an asset and liability on a net basis.

ii. Intentions to either settle on a net basis or to realize the asset and settle the liability simultaneously (which may be backed by past practice).

Para AG 38B of Ind AS 32 states that the right of set-off must not be contingent on a future event and must be legally enforceable in all the circumstances, i.e., normal course of business as well as in the event of insolvency, bankruptcy, etc. of the counterparties.

Accordingly, consistent with the current practice of most banking entities, very few transactions will qualify for offsetting. For example, in case of presentation of Interbank Participation Certificates (IBPC) with risk sharing, the issuing

bank would reduce the aggregate amount of the participation for the aggregate outstanding advances. The participating bank would present the aggregate amount of such participations as part of its advances. This accounting treatment for IBPC with risk sharing may not be in line with Ind AS 32 offsetting requirements. In fact, the banking entities would need to review the terms of their participation and assess whether they comply with the derecognition and offsetting requirements of Ind AS 109.

Ind AS 32 requires compound financial instruments, such as convertible bonds, to be split into liability and equity components, and each component to be recorded separately. Extant Indian GAAP entails no split accounting, and financial instruments are classified as either liability or equity, depending on their primary nature. For instance, a bond with a 10% annual coupon rate and conversion feature at maturity, which entitles investors with fixed number of equity shares against fixed amount of maturity proceeds, may get classified as a compound financial instrument under Ind AS. This may have an impact on the capital management of the bank as bond which was considered as debt obligation under the extant Indian GAAP may have some portion attributed to equity.

8. Classification of Financial Assets

Ind AS 109 contains three classification categories for financial assets:

a. Amortized cost

b. FVOCI

c. FVTPL

A financial asset is subsequently measured at amortized cost if the asset is held within a business model whose objective is to collect contractual cash flows and the contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest (SPPI).

A financial asset is subsequently measured at FVOCI if it meets the SPPI criterion and is held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

All other financial assets are classified as being subsequently measured at FVTPL.

At initial recognition of an equity investment that is not held for trading, an entity may irrevocably elect to present in Other Comprehensive Income (OCI) the subsequent changes in fair value.

However, under the extant RBI guidelines, the classification categories currently prescribed are Held to Maturity (HTM), Available for Sale (AFS) and Held for Trading (HFT).

9. Classification of Financial Liabilities

Under Ind AS 109, all financial liabilities are classified into two categories: FVTPL and other financial liabilities. The initial measurement of all financial liabilities is at fair value. Subsequent to initial recognition, FVTPL liabilities are measured at fair values, with gain or loss (other than gain or loss attributable to "own credit risk") being recognized in the income statement. Gain or loss attributable to "own credit risk" for FVTPL liabilities is recognized in equity. Other financial liabilities are measured at amortized cost using the effective interest rate for each balance sheet date. Under extant Indian GAAP, no accounting standard provides detailed guidance on the measurement of financial liabilities. The common practice is to recognize the financial liability for consideration received on its recognition. Subsequently, interest is recognized at the contractual rate, if any.

10. Accounting for Derivatives

Ind AS 109 defines a derivative as a financial instrument or a contract having the following three characteristics:

i. Its value changes in response to the change in a specified interest rate, financial instrument price etc.

ii. It requires no or smaller initial net investment.

iii. It is settled at a future date.

As per Ind AS 109, all derivatives, except those used for hedging purposes, are measured at fair value, and any gains/ losses are recognized in profit or loss.

In the context of banking in India, instruments such as interest rate swaps (IRS) are accounted as per RBI circular MPD.BC.187/ 07/01/279/ 1999–2000 dated 7th July 1999. Hence, market transactions done by banking entities are marked to market (at least at fortnightly intervals), whereas those for hedging purposes could be accounted on an accrual basis. This accounting treatment for IRS under the extant circular is different from Ind AS 109, which requires all the derivatives to be categorized as FVTPL. Even the hedging accounting model under Ind AS 109 is at variance with the extant circular.

Ind AS 109 requires extensive use of fair valuation for the classification and measurement of financial assets. Considering the economic environment and lack of relatively developed financial market for certain foreign exchange and interest rate instruments, the application of these fair valuation techniques requires additional implementation measures to overcome the challenges.

B. Impact of Income Computation and Disclosure Standards on Taxation of Banks

ICDS VIII mentions that this ICDS is not applicable to banks but carves out the applicability to scheduled banks and public financial institutions and says that they will be governed by the valuation rules prescribed by Reserve Bank of India ("RBI") and any excess claim over and above the said guidelines by RBI will not be acceptable. As per Reserve Bank guidelines securities classified as Held for Trading ("HFT") and Available for Sale ("AFS") will be marked to market scrip wise and aggregated category wise under HFT/ AFS and only net depreciation if any will be provided for in the books of accounts. The same also has been re-iterated by CBDT through Instruction No. 17/2008.

The issue valuation for securities for Banks has already been dealt by various Courts including Bangalore Tribunal in the case of *ING Vysya Bank Ltd vs. ACIT* (TS-5085-ITAT-2015 (Bangalore)-O) wherein it was held that assessee is entitled to value all the securities which are part of trading stock at cost price or market value and claim depreciation due to diminution in value of each such share and not category wise as it could lead to recognition of appreciation thereof which is in the nature of notional income.

CASE STUDIES

In a recent case, deduction claimed by a private bank under Section 36(1)(viii) was examined and disallowed. The modus operandi and the method followed to disallow the same is explained as follows:

Case Study 1: Deduction under Section 36(1)(viii)

36(1)(viii) provides for a deduction in respect of any special reserve created and maintained by a ***specified entity,*** an amount not exceeding twenty per cent of the profits derived from ***eligible business*** computed under the head "Profits and gains of business or profession" (before making any deduction under this Clause) carried to such reserve account:

A ***banking company*** is recognised as a specified entity as defined in the explanation to Section 36(1)(viii)

For a banking company, ***eligible business*** is the business of providing ***long-term finance*** for:

1. Industrial or agricultural development.
2. Development of ***infrastructure facility*** in India.
3. Development of housing in India.

(g) "infrastructure facility" means—

i. An infrastructure facility as defined in the Explanation to Clause (i) of Sub-section (4) of Section 80-IA,

or any other public facility of a similar nature as may be notified[45] by the Board in this behalf in the Official Gazette and which fulfils the conditions as may be prescribed[46].

ii. An undertaking referred to in Clause (*ii*) or Clause (*iii*) or Clause (*iv*) or Clause (vi) of Sub-section (4) of Section 80-IA; and

iii. An undertaking referred to in Sub-section (10) of Section 80-IB.

(h) "long-term finance"[47] means any loan or advance where the terms under which moneys are loaned or advanced provide for repayment along with interest thereof ***during a period of not less than five years***;]

The Keywords are Italicised and Printed in Bold Letters to Add Emphasis

The Banks generally carry on a single indivisible business having a common pool of resources and overheads. The Banks generally do not maintain separate books of accounts of income from long term finance eligible for special reserve and other business income.

In the absence of a prescribed method for working out special reserve,the Assessing Officer is called upon to compute profits derived from eligible business.

In one of the cases assessed to Income-tax in the Pr. CIT–2 charge, the following method has been used to calculate special reserve deduction. The same is produced as an example to compute special reserve deduction.

Step 1: Income from non-finance business is identified.

e.g., the income from following heads is identified

a. Rent and other charges.
b. Miscellaneous receipts.
c. Lease income.
d. Commission, exchange & brokerage.
e. Gains/ (losses) on trading.

Step 2: Expenses related to non-finance business–may be identified in following heads

a. Lease depreciation.
b. Administrative overheads @ 10%.
c. Interest Cost on lease rental income.
d. Interest Cost–Others–if any.

Step 3: Amount calculated as step1 less step2 provides net income from business other than finance

Step 4: The Bank may be asked to provide list of loans from which interest is recognised–by using the criteria laid down to define the long term finance–the ratio of long term finance to non-long term finance income may be calculated.

Step 5: The ratio in step 4 may be used to compute net income from long-term finance business

Step 6: Deduction available is calculated at 20% of net income from long-term finance business

Step 7: Deduction available will be least of:

a. Special reserve actually created
b. Amount calculated as in step 6

further where the aggregate of the amounts carried to such reserve account from time to time exceeds twice the amount of the paid up share capital and of the general reserves of the specified entity, no allowance under this Clause shall be made in respect of such excess.

Case Study 2: Credit Card Business—Is it Banking Business? Bad Debts—Applicability of Section 36(1)(vii)—An Analysis

It was observed in few cases that the assessee bank during the course of assessment proceedings was claiming bad debt under Section 36(1)(vii) on account of credit card business.

The AO had asked the bank to justify the same in view of conditions laid down in Section 36(2)

The banks generally justify their claim by resorting to following arguments:

1. The Bank claims write offs of credit cards under Section 36(1)(vii) of the Act. The issue of credit cards, debit cards, prepaid cards are a part of Bank's business of lending and the RBI has issued guidelines with respect to the same.
2. As per RBI guidelines, Banks in India can undertake credit card business either departmentally or through a subsidiary company setup for the purpose. Banks can also undertake domestic credit card business by entering into tie-up arrangements with one of the banks already having business of issue of credit cards.
3. Banks desirous of undertaking credit card business either independently or in tie-up arrangement with other card issuing banks can do so with approval of their Board and no prior approval of RBI is required.

Therefore, the write-off of credit cards has been rightly claimed as bad debts under Section 36(1)(vii) of the Act.

These arguments do not hold good because of the following: Before the arguments are analyzed–it is proper to reproduce the extracts of the relevant Sections here

The Section 36(1)(vii) of the Act (reproduced below):

> *Subject to the provisions of Sub-section (2), the amount of any bad debt or part thereof which is written off as irrecoverable in the accounts of the assessee for the previous year:*
>
> *Provided that in the case of an assessee to which Clause (viia) applies, the amount of the deduction relating to any such debt or part thereof shall be limited to the amount by which such debt or part thereof exceeds the credit balance in the provision for bad and doubtful debts account made under that Clause.*
>
> *(Explanation 1).—For the purposes of this Clause, any bad debt or part thereof written off as irrecoverable in the accounts of the assessee shall not include any provision for bad and doubtful debts made in the accounts of the assessee;*
>
> *(Explanation 2.—For the removal of doubts, it is hereby clarified that for the purposes of the proviso to Clause (vii) of this Sub-section and Clause (v) of Sub-section (2), the account referred to therein shall be only one account in respect of provision for bad and doubtful debts under Clause (viia) and such account shall relate to all types of advances, including advances made by rural branches;)*

20.3.1 Further as per Section 36(2)(i) (reproduced below):

> *No such deduction shall be allowed unless such debt or part thereof has been taken into account in computing the income of the assessee of the previous year in which the amount of such debt or part thereof is written off or of an earlier previous year, or represents money lent in the ordinary course of the business of banking or money-lending which is carried on by the assessee;*

1. Deduction cannot be claimed for bad debt unless
   a. Such amount has been taken into account in computing the income in this previous year or an earlier previous year

      OR

   b. Represents money lent in the ***ordinary course of the business of banking or money lending***

sub Section 36(2) enables banks and moneylenders to claim even principal amount of loan as bad debt along with interest (interest which is otherwise the actual income of bank or moneylender). This is a special provision extended to banking business because of the peculiarities of the business and therefore this provision cannot be extended to businesses which are different from banking and moneylending.

2. The assessee is a banking company and credit card business is different from banking business. In this context

   a. It is observed that as per provisions of Section 36(1)(vii), the assessee is allowed deduction of any amount of bad debt or part thereof which is written off as irrecoverable in the accounts of the assessee. However, the aforesaid provisions are subject to the provisions of Section 36(2), which provide that deduction cannot be claimed for bad debt unless such debt has been taken into account in computing the income in the previous year or in an earlier previous years or it represents money lent in the ordinary course of the business of banking or money lending.

   b. The banking services are defined and controlled by the provisions of Section 5(b) and Section 6 of the Banking Regulation Act, 1949 and are essentially services arising from acceptance of deposits of money from the public. Credit card services can be carried on by any person including non-banking financial institutions. One need not be a customer of a bank to avail and use a credit card. Thus, the credit card services are not part of the business of banking.

   c. The activity of offering of credit cards in India is not the business of money lending. The activity is mainly carried out through the provisions of the services provided by two American Companies i.e. Visa card and Master card. These two American companies have signed agreements with shops, establishments, enterprises that they would accept payments by cards on purchase of goods and services made by the customers. The banks have also been taking help from Visa and Master cards by paying fees and on the strength of their agreements with these two American companies banks have issued cards to various customers. The customers or the card holders holding the cards of the bank issued in association with Visa and Master card can make purchases without carrying any money. After the transaction of purchase and services is made the data gets electronically transferred to the computer base of Visa or master card and after the settlement the amounts are intimated to the banks by the card operators. The bank then raises the bills on their customers and gives them a grace period. If the customers make payments within the grace period no interest is charged by the banks. The bank also gives an option to the cardholders to pay by EMI with interest and service charges. From the above description, it is clear that the banks by issuing credit card does not carry out the business of money lending, but acts only as service provider or as agent of the card issuer companies such as Visa or master card. Therefore, the bad debts incurred with regard to issuance and services of credit cards are neither related to banking business or business of money lending."

Therefore, credit card business is a payment service and not a business of banking or money lending as defined in the Banking Regulation Act 1949—the card issuer (assessee in this case) earns a service fee and in not-so-regular cases when the cardholder defaults, a penal interest is charged on the cardholder for not honoring his promise to the card issuer.

In view of the above—the bad-debt claim of credit card business fails on both restrictions imposed in 36(2)(i)

a. The credit card bad debts were never taken into account for computing income

and

b. This does not represent money lent in the ordinary course of business of banking

Therefore, this amount does not qualify to be claimed under Section 36(1)(vii) of the IT Act, 1961.

Further, Section 37(1) says that any expenditure (not being expenditure of the nature described in Sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head, "Profits and Gains of Business or Profession". Therefore, when there is a specific provision available in Income-tax Act in the form of Section 36 for claiming bad debts-Section 37 cannot be considered for allowing this claim of bad debt.

In view of the above analysis and discussion—the claim made by a banking company of bad debts pertaining to credit card business cannot be allowed as the bad-debt claim of credit card business fails on both restrictions imposed in 36(2)(i) which are one: the credit card bad debts were never taken into account for computing income and two: this does not represent money lent in the ordinary course of business of banking.

Case Study 3: Loss on Revaluation of Securities

One of the banks claimed in its return a deduction of Rs. 30 Crores which represented depreciation including depreciation on permanent investments in the computation of income. Bank's case was that it treated its whole investment as stock-in-trade and that the artificial bifurcation of investments into current and permanent category of investments was pursuant to the guidelines of Reserve Bank of India from 1992–93. The Assessing Officer rightly disallowed the loss on permanent securities as he was of the view that the bank should have followed a uniform system of accounting. If the method of accounting was once changed as per the system prescribed by the RBI, it could not have followed another method for taxation purpose for pressing its claim for 'amortisation of loss' on account of permanent securities. The basic premise of law was that loss not incurred cannot be allowed whatever be the treatment in books of accounts of the assessee. Further, the Income-tax Act permits indexation of the cost of acquisition for neutralizing the cost of inflation. This being the position of law, assessee's claim for loss on revaluation of assets categorised as depreciation on investments was not valid under Income-tax law and was rightly rejected by the Assessing Officer.

Case Study 4: Interest on Refunds Issued under the Income-tax Act, 1961

During the course of scrutiny of one assessee bank AY 2015–16, it was found that the assessee bank was issued interest under Section 244A amounting to a total of Rs 856 crores on account of rectification and orders giving effect to order of various appellate authorities during the relevant previous year, i.e. FY 2014–15. Also, during the said previous year, interest under Section 234B amounting to Rs 455 crores was charged to the assessee bank at the time of finalization of assessment for AY 2013–14. From perusal of return of income, it was seen that the

assessee bank had offered only an amount of Rs 402 on account of interest on refund as against an amount of Rs 856 crores actually issued to assessee as interest under Section 244A. Further details were called from the assessee on this issue. From perusal of submission of the assessee, it was seen that the assessee has claimed deduction of Rs 455 crores on account of interest paid to the department during the year against the refund amount of Rs 856 crores received during the said year. In view of the facts of the case, provisions of Section 40(a)(ii) are squarely applicable. The subclause (ii) of Clause (a) of Section 40 clearly lays down the position of law that "any sum paid on account of any rate or tax levied on the profits or gains of any business or profession or assessed at a proportion of, or otherwise on the basis of, any such profits or gains" shall not be deducted in computing the income chargeable under the head profits and gains of business or profession. Thus, in view of the foregoing position of law, the deduction of Rs 455 crores claimed by the assessee was disallowed.

CHECK LIST FOR ASSESSING OFFICERS

1. To check if the assessee bank has complied with the regulations of the RBI, SEBI and other regulatory bodies. Any wrong claim made by the assessee bank under any law of the land shall not be permissible under the Income-tax Act, 1961.
2. For deduction under Section 36(1)(vii), the amount of bad debts claimed during the current year should be debited to the provision for bad debts made under Section 36(1)(viia). Only that amount of bad debts which is greater than the *opening balance of the provision* created under Section 36(1)(viia) is allowable as a deduction under Section 36(1)(vii).
3. Amount claimed as deduction under Section 36(1)(viia) should be subject to the upper limits as prescribed in the Act. *(Refer 36(1)(viia))*. Even if total income is enhanced during course of assessment, thereby increasing the permissible limit under Section 36(1)(viia), the amount of deduction should not exceed, in any circumstance, the actual amount of provision made under Section 36(1)(viia).
4. Also make sure that the assessee is not claiming deduction under Section 36(1)(viia) for provision made for standard assets.
5. Verify if Rural branches shown by the assessee are indeed rural branches according to census figures.
6. 115JB is applicable to all banks, including public sector banks. Check if the assessee bank claims otherwise.
7. In case of amalgamation and de mergers, check for any goodwill that is shown to have arisen, whether such goodwill really corresponds to any underlying intangible asset or not and whether depreciation claim on such goodwill is allowable.
8. Verify if the type of lending as shown by the assessee for 36(1)(viii) claim corresponds to the permissible types of lending as prescribed in the Section. Also verify if r
9. The assessee bank's books are audited regularly (quarterly). Verify if any discrepancy has been pointed out by auditors.
10. Check for claim of provision for wage revision/ provision for pension, determine whether crystallized liability or contingent liability.
11. Check for admissibility of 80P deduction claim by a Cooperative Bank.
12. Check admissibility of claim of ESOP expenses by the assessee.

13. Check is assessee has debited any interest expenditure as broken period interest on acquisition of HTM Securities, by artificially dividing the purchase price into acquisition cost and broken period interest.
14. Check whether the assessee has offered interest accrued but not due to tax or not
15. Check if the assessee has made disallowance under Section 14A of the Act in accordance with Rule 8D. Remember that the assessee cannot make omissions in inclusion for investment value or otherwise, for the purpose of disallowance according to Rule 8D.
16. Check if the assessee has apportioned any amount as "provision' and claimed the same as deduction. For such deduction to be allowed, the liability is to be crystallized. (including Provision for Foreign Taxes.)
17. Check if the assessee has claimed any depreciation on investments purchased under the "HTM" category.
18. Check applicability of provisions 43D read with Rule 6EA.
19. Check for deduction claim on Provision for leave salary–applicability of 43B.
20. Check if any amount shown as income in books as Recovery on written of accounts has been claimed as deduction while computing total income.
21. Check whether Income from Foreign Branches has been excluded while computing the total income of the assessee. Refer to Section 90 and relevant DTAA.
22. Check if assessee has claimed any amount as "Loss on revaluation of securities" and allowability of the same.
23. Check is assessee has claimed any expenditure as deduction on interest paid on "Innovative Perpetual Debt Instruments."
24. Check if the assessee has claimed any deduction under Section 36(1)(vii) on account of bad debts from credit card business.
25. NBFC are indulging in entry operator rackets. Their bank account analysis gives the entire chain of bank accounts used for circular transaction.Investigation of KYC document of NBFC may reveal undisclosed accounts.
26. Bank account of NPA account may reveals the source of fund of party who is in distress. Enquiries reveal that parties are paying money from their unaccounted money.
27. After demonetization there is a trend to withdraw cash for unaccounted expenses. Details may be sought of those accounts wherein substantive cash withdrawals were made.
28. TDS violations on high interest bearing so called saving bank accounts.
29. For foreign banks in India:
    i. Check for limitation to head office expenses under Section 44C
    ii. Any common group expense claimed as deduction by the assessee on apportionment basis.
    iii. Salaries paid to expatriate employees, claim of deduction, applicability of TDS
    iv. Interest received and paid to Head Office
    v. Refurbishment expenses
    vi. Types of Transfer pricing adjustments possible.

Note: Check list is only for reference and is not exhaustive.

SAMPLE QUESTIONNAIRE

1. Please submit computation of income for AY 2016–17 with ITR-V and return of income (hard copy of ITR form), Tax audit

report and audited final accounts along with copies of mandatory reports filed with the Reserve Bank of India and/ or Registrar of Companies for the year under consideration.

2. Please submit a detailed note on nature of business of the assessee company explaining in detail the business model with emphasis on principal activities which result in revenue generation. Also, please submit details of registered office address of the assessee bank as well as principal place of business as on the date of this letter, details of branch offices with complete address, telephone numbers, email address and details of business activities carried on there from.
3. Copies of assessment order under Section 143(3)/143(3) read with other Section of the Income-tax Act, 1961 for 2 latest assessment years.
4. Assessment year wise summary of various additions in the orders as mentioned in point no. 3 above.
5. Copy of form 26AS.
6. Please give details of expenses on account of broken period interest claimed during the year. In addition, please furnish details of incomes on account of broken period interest earned during the year and whether the same has been offered to tax.
7. Please give details of incomes on account of interests accrued but not due during the year. Please furnish your submissions with respect to taxability of said interest in the hands of the assessee bank during the year.
8. Please give details of all deductions claimed on account of provisions (other than bad and doubtful debts) claimed during the year. Please submit a note on allowability of such provisions in accordance with the Income-tax Act, 1961.
9. Please give details of expenses claimed under the head staff welfare expenses giving particulars of such expenses. Further, please establish that such expenses have been incurred wholly and exclusively for the purpose of business in accordance with Section 37.
10. Please give source-wise details of exempt income earned during the year. Further, please make your submission with respect to applicability of Section 14A in view of exempt incomes earned by the assessee. In addition, please furnish a working of such disallowance in accordance with Rule 8D of the Income-tax Rules.
11. Please give details of any expenses claimed on account of loss on revaluation of investments or depreciation on investment and allowability of same as per the Act.
12. Please give details of any expenses claimed on account of amortization of premium paid on HTM securities and allowability of same as per the Act.
13. Please give details of expenses incurred on account of depreciation of leased assets and allowability of the same.
14. Please give details of expenses incurred during the year where there is an implication on account of Section 43B such as employee benefit expenses, tax/ duty/ cess etc. under any law, interests to public financial institutions/ scheduled banks and whether such expenses were actually paid.
15. Please furnish details of deduction claimed under Section 36(1)(viia) together with supporting documents such as copy of ledger account maintained for the purposes of the Section.
16. Please furnish branch-wise details of rural advances as required in accordance with provisions of Section 36(1)(viia).

17. Please give details of deduction claimed under Section 36(1)(vii) with evidence of compliance with Section 36(2)(v).

18. Please give details of deduction claimed under Section 36(1)(viii) together with working of such amount. Further, please furnish statement of income and expenditure of each of the eligible businesses with a note on such businesses.

19. Please make your submission with respect to taxability of interest accrued on bad and doubtful debts in accordance with Rule 6EA of Income-tax Rules.

20. Please give details of CSR related expenditure incurred in accordance with RBI notification dated 20/12/2017 and/ or Section 135 of the Companies Act, 2013. The same has not been added back in the computation of income in accordance with Section 37 of Income-tax Act. Please explain.

21. Please explain if any expenses have been incurred on account of interest paid for Innovative Perpetual Debt Instruments during the year under consideration. Please explain why these instruments are not akin to tier 1 capital and why the interest paid on the same is not akin to dividend payment. Further, as these are not borrowings in the sense of Section 36(1)(iii), please explain why interest expenses incurred on account of the same should not be disallowed.

22. Please give details of recoveries in written off amount and whether the same has been offered to tax during the year.

23. Please submit details of foreign incomes in the following format:

    23.1 Details of incomes earned by the assessee in foreign jurisdictions in the following manner:

    23.2 Details of deductions claimed as mentioned in table 1.

24. Please furnish details pertaining to loss on sale of assets ARCs and please explain the allowability of such loss as per the Act.
25. Please submit evidence with respect to TDS compliance as report in Form 3CD.

25. From the perusal of computation of income it is seen that the assessee has claimed deduction under Section 36(1)(vii). In this regard, please submit a working of how such figure has been arrived at.

    25.1 Also, from records, it is seen that the assessee bank is an assessee to which Section 36(1)(viia) applies. Please confirm your compliance to proviso to Section 36(1)(vii), which limits deduction under Section 36(1)(vii) to the amount by which bad debts written off exceeds the opening credit balance in the provisions for bad and doubtful account maintained under Section 36(1)(viia).

Table 1

S. No.	Jurisdiction/ Country	Currency	Gross income	Deductions Claimed	Net taxable Income	Taxes @Indian Rate	Foreign Tax Rate	Tax @foreign Rate	Tax Paid in Foreign Currency	Currency Conversion Rate	Tax Liability in INR Equivalent	Tax Paid in INR Equivalent	Balance Tax
1	2	3	4	5	6=4-5	7=6* 33.99%	8	9	10	11	12 = 7 x 11	13 = 10 x 11	14 = 13-12

25.2 Further, in view of provisions of Section 36(1)(vii), your attention is invited to the explanations to this Section. In this regard, please confirm that any part of bad debt written off does not include provision for bad and doubtful debts maintained in the accounts of the assessee.

25.3 Also, please furnish copy of provisions for bad and doubtful account maintained under Section 36(1)(viia) for the period 01/04/2015 to 31/03/2016. In addition, please demonstrate that requirements of Section 36(2)(v) have been complied with.

26. Please explain why no deduction has been claimed under Section 36(1)(viia). In the likely event that your claim under Section 36(1)(vii) may be rejected while finalizing the assessment proceedings, you are hereby required to present your claim under Section 36(1)(viia).

CHAPTER

3

Chit Funds

1. INTRODUCTION

1.1 Chit fund was invented as an alternative to the usurious moneylender. In those old days, when banks were yet to strike roots in rural areas, it was the moneylender who was calling the shots. The resourceful among the harrassed people invented a novel way of accommodating each other. A number of people formed a group. As members they pooled their moneys in a pond. Then lots were drawn and the winner got the sum so pooled. This process continued at successive intervals, say weekly, fortnightly, monthly or daily, as many times as the number of members. Every member stood a chance to have the prize once. This arrangement was called chit since the selection of member who got the sum was done by writing the name of each member on a chit and then picking one of the chits by lots. This is also called kuri or chitti in some parts of South India and kitti in Northern India.

2. THE SCHEME

2.1 In the chit scheme, once a member gets the prize, his ticket is ignored for the later draws, tenders, auctions etc. Irrespective of the fact that the member is prized or not he continues to pay his share, throughout the process at each successive interval. Every member is identified with a ticket number. The member's contribution is called the subscription. Each successive interval is called the instalment. The collective sum which passes through the draw is called the prize. The person who organizes the whole exercise is called the foreman.

2.2 The Salient Features of a Chit Scheme

i. Every member subscribes equally.

ii. The subscription value to a member is the same for all installments.

iii. Every member receives the prize only once.

iv. All members receive the prize which is equal in value.

v. The number of members (tickets or subscribers) and the number of installments are same.

vi. The number of prizes and the number of members are same.

vii. The total subscription in value for one instalment is equal to one prize in value.

2.3 Auction is a process of open competition among the subscribers to purchase the prize amount of the chit. It involves biddings by the subscribers. The purchase price will be as high as the necessity of a subscriber. The needs vary from subscriber to subscriber and accordingly the purchase price varies. The prize amount will be declared in favour of the member who is the highest bidder. After all, the motive of chit fund is only to enable the subscriber to meet the emergent needs like medical treatment, weddings and long distance travels. These cannot wait and the subscriber does not mind paying the price to get the money. Practically, the tendency to bid in auction is evident only in the beginning. Half way through, very few members have interest in the auction. For the last few installments, there may not be any auction at all. When there is no auction, the prize is declared by a draw. It is not open to the prize winner to participate in a future auction.

2.4 Auction dividend is the amount of purchase price received in consideration of the prize from a prize-winner in an auction to distribute among the subscribers equally. The auction dividend is also called variously as auction benefit, auction discount and auction profit. How the auction dividend is shared depends upon the bye-laws or rules of the concern which conducts the chit. The maximum amount of discount a chit subscriber can forego is 30 per cent. The foregone chit discount is distributed among the chit subscribers as chit dividend. As an incentive for timely payment of the subscription and safeguard against delays conditions may be imposed for eligibility to get the auction dividend. Some foremen impose time limits for claiming the discount of auction dividend. In such cases the share of auction dividend of such of those members who could not remit their subscriptions in time is forfeited. They do not get the auction dividend.

3. THE FOREMAN

3.1 The foreman is the moving force behind a chit fund. He is the one who organises and runs it. He lays down the rules for the operation of the chits, subject, of course, to the statutory requirements. He has various functions to perform. He has several powers which he can exercise.

3.2 Prompt subscriptions make the chit fund healthy. In normal course, all businesses bear the risk of bad debts. Chit fund business is no exception. More defaulters will make the chit fund sick, bankrupt and bring its shutters down. What is default is defined by the foreman in the rules of the chit chartered before commencing the chit. The foreman reserves the right to forfeit the ticket. Again, what is forfeiture is defined in the rules. The chances of a prize-winner becoming a defaulter are less because the foreman takes all necessary precautions before parting with the prize amount.

3.3 What should be the extent of forfeiture is defined by the foreman in the bye-laws/ rules of the chit. The forfeiture of the member's ticket occurs only in cases of non-prized members. The foreman will have the right to deny membership to non-prized members when they default. Generally, foremen take away the entire amount of auction dividend and fixed dividend credited to the defaulter's account till the date of the default. Only the net amount received physically in cash is considered for refund. The foreman also reserves the right to sell the forfeited tickets (seconds or silver tickets). A layman may feel that default by a member means a good deal of loss to foreman. It is not so. The actual sufferer is the defaulter himself. He has to pay commission to the foreman; and bear the loss of valuable time- of months, even years. Apart from the defaulter himself, the later winners also suffer financially.

3.4 In general, foremen fix their level of risk at the 5th installment or lower and accordingly determine the quantum of fixed dividend and commission in a chit of 100 installments. It is a practical observation that there are no defaults upto the 6th to the 8th installments. If he plans well, the foreman does not suffer any loss on account of defaults. He need not exercise his

right only on the date of default. He can at his discretion to forfeit the ticket any time before the chit is terminated. It is also open to the member to pay the arrears and regularise his membership at any time so long it is not forfeited. That is why most foremen do not forfeit the tickets but keep them alive in order to accumulate the dividend share to that ticket. With this treatment, he can increase his profits. Also, it earns for him a fund of goodwill among the subscribers. However, it is not obligatory for the foreman to pay the prize amount to the defaulter but forfeit the ticket as soon it is prized. Many foremen prefer to forfeit the ticket after it is prized instead of on the date of default. By this course, he avoids the outflow of the one-time prize amount.

4. FOREMAN'S EARNINGS

4.1 The foreman should have remuneration for his efforts in running the chits. He is the force behind the chit scheme. He renders various services such as collecting the chit subscriptions, handling the auctions and maintaining the books of account. The remuneration may be fixed or it may vary as a percentage of the collections. A foreman may be an individual, a partnership firm, a society, a private limited company or any one else. At present, payment of commission rather than remuneration is more popular. Before commencing the chit, the foreman is expected to specify his remuneration or commission and its treatment in the bye-laws or chit rules. Normally a fixed percentage on the chit prize is charged and deducted as commission before effecting the payment of the chit prize to the winner. A foreman is entitled to 5 per cent of the chit value as commission.

4.2 Foreman's earnings are not restricted to commission only. If rules permit, the foreman may also subscribe for one or more tickets. The foreman generally takes up one ticket. He can take up more, if so minded. His participation in the chit reassures the others about the soundness of the scheme. The auction dividend earned by the foreman on his own chits is popularly known as bonus.

4.3 Apart from commission and bonus the foreman gets following other receipts also:

i. Interest on fixed deposits.

ii. When a.prize winner fails to offer adequate security against future subscriptions, the foreman retains the amount in full or to the extent of future subscriptions till the chit is terminated. (However it becomes foreman's duty to adjust and credit towards the subscriptions on due dates).

iii. Profits realised on sale of forfeited tickets. These are known as seconds.

iv. Profits realised on forfeiting the tickets.

v. When unclaimed dividends are forfeited or dividends forfeited according to the rules.

vi. When subscriptions are received in advance. (However it becomes the duty of the foreman to adjust towards the subscriptions on due dates).

5. ACCOUNTS & ANALYSIS OF ACCOUNTS

5.1 Before going to the accounts one should be clear how the terms 'arrears' and 'dues' are used in chit fund business. The term 'dues' is used only with respect to prized members. The installments receivable not now but at a future date are called 'dues'. When a subscriber, whether prized or non-prized, fails to make payment on the due date it is said to be in 'arrears'. The term 'arrears' refer to the past transactions and the term 'dues' to the future transactions. Chit Subscription Account reveals the amount received from the non-prized subscribers only. Chit Prize Account reveals the subscription due from the prized subscribers only. Auction Dividend Account reveals the amounts, which have to be distributed to the subscribers.

5.2 Like any other investment transaction, subscription to chit is like deposit and the amount paid for chit subscription is to be accounted as asset till any amount is received in return subsequently. In practice, chit subscription could

be accounted as per two methods, i.e., (i) net payment method and (ii) gross method.

In net payment method, the amount paid towards chit excluding any dividend or kasar is debited to the chit account being an asset account. Any amount received from the chit upon bidding, etc., is credited to chit account. Upon closure of chit, the profit or loss from the chit subscription is transferred to profit and loss account or revenue account or capital account.

In gross method the amount received towards kasar or dividend is treated as income when it is due or received. The gross amount of instalment is debited to chit account and when the chit is bid, the amount forgone by the subscriber is debited as expenditure. The chit account will automatically tally upon completion of chit.

The amount of discount representing the amount foregone by the subscriber is either claimed as expenditure relating to the year of bidding or a portion of claim is deferred to the subsequent periods in which the balance numbers of instalments are due.

For example, if the chit tenure is 30 months with subscription amount of Rs. 5,000 every month and the subscriber has bid the chit in the 18th month, say, in March 2017 for Rs. 1,20,000, the amount representing discount of Rs. 30,000 would be claimed as expenditure for the year ended March 31, 2017 or the discount of Rs. 18,000 would be claimed as expenditure for the year ended March 31, 2017 (i.e. Rs. 30,000 × 18 months/30 months) and the balance of Rs. 12,000 as expenditure relating to the previous year 2017–18 (i.e. Rs. 30,000 × 12 months/ 30 months).

5.3 Investigating the chit business is better done by taking any one chit and see how the various accounting entries have been made from the beginning of the chit to its termination. This way, it is easy to find out whether income receipts have all been properly taken to the profit and loss account and not to the balance sheet as liabilities. For a chit to run, it should be subscribed fully. To make up the numbers sometimes fictitious subscribers are introduced. A look into the subscriber's register, with a particular eye for tell-tale markings, may provide useful clues in this regard. If in the case of a subscriber, the subscriptions paid are entered in one lump just before the subscriber gets the prize, it can be reasonably deduced that he is a fictitious subscriber. Hence, a scrutiny of the subscriber's register is essential.

5.4 In chit fund business as in any other business, items of expenditure might have been inflated. items like salary paid, commission paid for canvassing subscribers and gifts given to subscribers or agents are particularly vulnerable to inflation. For enrolling chit subscribers, canvassing agents are usually paid 1 per cent of the chit value as commission. Anything more than this can be considered as not normal and enquiries should be started.

6. THE ACT & RULES

6.1 There is a Central Act called The Chit Funds Act 1982 governing the running of the business of chit funds. This Act is not applicable to the state of Jammu and Kashmir. Various states have prescribed rules governing this business. A licence is compulsory for carrying on this business. Almost all states require the chit bye-laws to be registered before a chit is started. An application is expected to be made to the Registrar of Chits after the payment of the prescribed fee. License is a general permission to carry on the business of chit funds whereas registration of bye-laws is a sanction to commence the particular chit. The chit concern is required to invest an amount equal to the chit value in a bank fixed deposit and endorse it in favour of the Registrar. It can withdraw the deposit only with the permission of the Registrar that too after the conclusion of the chit. The foreman is entitled to get the prize in the first or the second auction.

6.2 The law expressly prohibits carrying on of any business other than the chit business under the same name. The total value of chits is

restricted to Rs 25000 for proprietor, Rs 25000 per partner subject to Rs. 1 lakh in the case of firm and ten times the paid-up capital in the case of companies. The foreman has to submit periodic statements with the Registrar at the end of each year. Chit Inspectors of the Registrar periodically inspect the place of business and the accounts and other records for ensuring compliance with the rules and regulations. The Registrar after satisfying himself about the bona fide completion of the particular chit orders the release of the fixed deposit lying with him.

7. PAPERS & DOCUMENTS

7.1 The registers and documents important from the point of view of tax investigations are- The chit agreement, the minutes of draw and the reckoners. They are the books recording the developments contemporaneously. The chit agreement is a crucial document entered into between the foreman and the chit subscriber. It contains the terms of the chit.

7.2 The minutes of draw is prepared for every draw. They are entered in a book kept for that purpose and signed by the foreman and all the subscribers present. It is also signed by the prized subscriber or his authorised agent. It records the proceedings of the draw and contains the following among other things-

The amount of discount.

Full particulars regarding the disposal of the prize amount in respect of the preceding instalment and disposal of unpaid prize amount, if any, in respect of any previous instalment.

There shall be a separate register to record the proceedings. It shall be signed by the foreman and all the subscribers present at draw. The most important condition is that it shall also be signed by the prized subscriber or his authorised agent.

7.3 The reckoner is a hand book of the cashier who receives the subscriptions. It provides ready information regarding the gross auction dividend, the fixed dividend and the foreman's commission. The entries in the reckoners are made soon after the draw/ auction is concluded.

8. KURI COMPANIES OF KERALA

8.1 The chit fund companies of Kerala operate differently from the chit fund companies functioning in the other parts of the country. The Government of Kerala has passed the Kerala Chitty Act, according to which the auction amount is restricted to 30 per cent of the total prize amount. When there are more than one contenders for the auction, the winner is decided by a lot. Thus, effectively the auction also turns out to be based on taking the lot. Majority of the chit fund companies in Kerala conduct kuri business by starting a branch in either Jammu or Faridabad thereby extricating themselves from the regulations of the Chitty Act. Only the government-owned Kerala State Financial Enterprises is conducting chitty business as per the provisions of the Chitty Act.

8.2 There are no restrictions on auctioning in respect of kuris started from branches in Jammu and Kashmir and Haryana. Hence, most of the kuri companies functioning in Kerala have a namesake branch in these places. The entire business activities are carried out in Kerala and there is only a name board in Faridabad or Jammu. As per the provisions of the Act if the Kuris are started from the Faridabad branch the prizing and auctioning also has to be done in that branch. But this is not observed by any of the chit companies although they are debiting travelling expenses and stay expenses once in a month resulting in generation of unaccounted income to that extent. Some of the kuri companies even claim plane charges for going to Faridabad and Jammu. The charges so debited though actually not incurred are shared among the directors of the kuri companies.

8.3 The kuris in Kerala have got total prize amount varying from Rs. 10,000/- to even Rs. 50 lakhs. The kuris are either monthly kuris or quarterly/ poovalkuries in which subscriptions

are to be paid once in a quarter or once in four months respectively. In kuris of bigger prize amount, called 'sala', the monthly subscription is as high as Rs. 25,000/-. For example; a kuri with monthly subscription of Rs. 25,000/-running into 200 installments (poovalkuri once in four months) the total sala is Rs. 50 lakhs. Out of the Rs. 50 lakhs the prize amount is Rs. 40 lakhs. The balance amount of Rs. 10 lakhs is divided into foreman commission of Rs. 4 lakhs, bonus for prompt payment to subscribers Rs. 2 lakhs and the balance amount of Rs. 4 lakhs is to be divided among non-prized and non-bid subscribers. The same scheme holds good even in kuris of smaller subscription.

8.4 The incomes derived by the kuri companies are chiefly the following:

a. Foreman Commission.

b. Interest on delayed payment of monthly/ quarterly subscription.

c. Premium on forfeited kuris.

These incomes are invariably recorded in the books and reported for tax purposes. However, there are certain other incomes which go unreported. Expenses are sometimes inflated and a part of the income taken away from taxation.

8.5 Some of the ways in which concealment is attempted in these cases are:

8.5.1 Profit on transfer of prized/ auctioned kuris—Most kuris started from Faridabad/ Jammu branches have got the system of prizing and auctioning simultaneously. In the case of prized subscribers the company offers premium for transfer of the prize amount to needy customers. This premium is shared between the company and the prized customer totally outside the books. If a kuri of prize amount of Rs. 1 lakh is prized by a subscriber during the early stages of the kuri, premium of upto Rs. 50,000/- is available. Even for auctioned kuris some kuri companies give premium and transfer the prize amounts to needy customers.

8.5.2 Subscription in company's own name-Usually, kuri companies subscribe to a large number of tickets in their own names. Some of the companies resort to unfair means in taking lots with the result that the winners of the lots are the company tickets. These are then transferred to needy customers on their paying hefty premium.

8.5.3 Bogus liability claim—In almost every kuri there are a number of defaulters. As per the rules of the company, if there is continuous default for more than 3 months, the subscribers forfeit their subscription. At the closure of the kuri, these amounts are supposed to be returned to the subscribers. In actual practice, the company claims the amount as liability but never returns it. After some time, it may show the amount as paid without making any payment at all.

8.5.4 Interest on passbook loans—Generally, kuri companies grant loans on the security of non-bid/ non-prized passbooks. The loan amount may be as much as 60 per cent of the actual amount remitted by the subscriber. The company charges interest on such loans at high rates. The books reveal only a nominal interest. Through enquiries the truth can be culled out.

8.5.5 Interest on advance payment of kuri prize/ bid amount—As per the kuri rules, the prized/ bid subscribers are entitled to profit the amount after ten days of the next instalment, i.e. after 40 days in the case of the monthly kuri, 100 days in the case of the tri-monthly kuri and 130 days in the case of poovalkuri (kuri conducted once in four months). This period is provided for in the kuri rules in order to give time to submit adequate security by the subscriber, verification and acceptance of the same by the foremen and for executing necessary bonds. The traders who join the high denomination kuris are often in need of funds for their business purposes. Waiting for such long periods may not suit their business needs. They approach the foreman to realise the bid/ prize money ahead of the due dates. Usually, the foreman allows the subscriber to draw the

prize/ bid amounts but charges interest @ 18% to 30% per annum for the period from the date of payment to the due date. Such interest is rarely offered for assessment. Hence, all cases of advance payments should be checked for the interest collection.

8.5.6 Profit on terminated kuri—The prized/ bid subscriber loses the benefit of auction, discount, fixed discount and bonus when he fails to remit the subscription on due dates. In a case of three consecutive defaults, the ticket is treated as forfeited and such subscriber is entitled to get only the amount paid by him as reduced by the foreman's commission. All benefits accruing to his ticket are denied. All these discounts/ bonus forfeited are the income of the foreman. However, in most cases no such income is disclosed. This is on the plea that under the scheme of the kuri, profit or loss can be ascertained only at the time of its termination. Even after the termination, the profit is not offered for assessment on the plea that large amounts are due from the subscribers and the profit can be brought to tax only after all the dues are collected. The final accounts filed along with the returns of income seldom disclose the fact of termination during the relevant year. The financial accounts are made by the companies usually in three parts:

a. Profit and Loss Account.

b. Kuri Statement.

c. Balance Sheet.

The kuri statement depicts the assets and liabilities of all chitties conducted. The statement is tallied with an item called 'company account' This item is brought to the balance sheet. On a perusal of the kuri statement one can see liabilities of crores of rupees under auction discount payable account, fixed discount payable account and bonus payable account. The statement never gives an item wise tally as to which kuris the payable account relates. If these payable accounts are analysed, one can see that a good portion of the credit balances of these accounts pertain to terminated kuris and are non-existent liabilities which should have been offered for taxation much earlier. After the termination of the kuris the foreman is not legally bound to give any discount or bonus and such liabilities cease to exist. They are his income.

8.6 In kuri business inflation of expenses takes place in the following ways:

8.6.1 Inflation of travelling expenses—As already mentioned, the kuris are shown as run from branches in Haryana and Jammu. To give a semblance of reality, the companies debit travelling expenses for their employees and directors which are not actually incurred. The bogus nature of the claims of the directors/ shareholders that they have attended the kuri auction in Jammu or Faridabad can be exposed by a mere verification of the minute book. In all probability the board meeting of the company would have taken place in Thrissur on the date on which the directors/ shareholders were supposed to have travelled to or on camp at Jammu or Faridabad. Besides, the director/ shareholder may be engaged in other businesses or professions. The record of his activities *vis-a-vis* such business/ profession may reveal that he was present in Thrissur on the date of his supposed tour.

8.6.2 Kuri Canvassing Commission: Whenever a kuri is started, commission is paid to the agents who canvass subscribers. Although it is claimed that the commission is paid to outsiders it is generally paid to the employees and directors of the company. Usually upto 20 per cent of the monthly or quarterly subscription is allowed as commission. A few companies may claim upto 40 per cent. The excess commission debited in the *P&L* account is shared among the directors and employees. Investigations done in kuri companies have exposed this practice which is prevalent in most companies. In some cases where the subscribers directly join the chitty, canvassing commission is claimed under bogus names and appropriated by the employees.

8.6.3 Daily Collection Commission: Kuri companies generally send their staff members called collection agents to collect kuri subscriptions from customers. A good number of subscribers remit subscriptions by way of cheques/ drafts. For this no effort on the part of the company is necessary. Many subscribers remit their subscriptions in the company's counter directly. The collection agents need to contact, if at all, only a small number of customers. However, in its accounts, the company claims that all collections were made through the collection agents. It claims upto 2 per cent as collection commission. This is bound to be inflated. The extent of inflation can be checked with reference to the cheque/ DD register, cashier's scroll and the records of the collection agents.

8.6.4 Business Promotion Expenses: Whenever kuris of bigger prize amounts are announced the company also announces cash incentives, gold coins, bumper prizes like Maruti car in order to attract more subscribers. Huge amounts are debited under the head 'business promotion expenses'. While a good chunk of the expenditure may be genuine, the remaining portion may not be so. This portion is appropriated by the directors. During some surveys conducted in kuri company cases this practice was detected. The genuineness or otherwise of the claim can be verified with reference to the pamphlets/ leaflets published at the time of commencement of the chit.

8.6.5 Incentives: Certain expenses in the nature of incentives are stated to have been incurred as prizes to subscribers who remitted subscription in time. This outlay is supposed to induce all subscribers to remit installments in time. Such a claim should be viewed with suspicion. Non-bid/ non-prized ticket holders who fail to remit subscriptions on due dates lose the bonus element and attract penal interest/ fine. The prized/ bid subscribers lose all discounts and bonus and attract fine/ penal interest if they default. Thus, it is evident that no further inducement to subscribers is necessary, and in fact paid, to ensure timely payment. Moreover, the kuri rules printed in the chitty pass book do not provide for such inducement.

8.6.6 Sitting Fees/ Conveyance Allowance to Directors: There are no specific rules as to the periodicity of meetings of the directors. Some companies conduct meetings weekly, some fortnightly and some monthly. The directors are paid large amounts as sitting fees, but in the accounts only much lower amounts are recorded. The 'sitting fee' so paid is more a sharing of unaccounted money collected during the earlier period. The sitting fee apart, the director is paid conveyance allowance also. Sitting fee and conveyance allowance are but one item divided and called by two names. This artificial division is made to reduce the tax liability of the directors.

8.6.7 Inflation of other Expenses Like Office Expenses, Kuri Preliminary Expenses, Commission, etc. Most of the companies inflate expenses under these heads with a view to reduce the profit. Proper vouchers are not kept in support of the expenditure claimed under the above heads. Due alertness on the part of the AOs will help greatly in checking and finding out the inflation in expenditure.

8.6.8 A clear understanding of the functioning of the chitties/ kuris is a must before any meaningful investigation is undertaken. The AO should familiarise himself with the chit procedures and practices and also the law governing the chits.

9. VIEW OF CBDT

9. The CBDT *Instruction No. 1175 under Order F. No. 169/21/78-IT (80) dated May 16, 1978* has stated as below:

a. "If any person organises Chit Funds and for this purpose brings the members together, administers the Chit Funds and thereby earns commission, etc., profits made by such a person is income from business and if for any special reason there is loss

then it is business loss. Normally, there should be no loss to the organiser unless he takes over the liability of some of the members. In such a case the un-recovered amount due from such members will have to be treated as bad debts and the test to be adopted in usual business assessment for the allowance of bad debts would be applicable in such cases also.

b. In the hands of the subscribers, a few will be receiving more than what they have subscribed. This extra amount is in the nature of interest and as such, taxable. Members who take the money earlier from the chit will necessarily have to contribute more which means that they incur loss, which is nothing but interest paid for moneys taken in advance. The claim of such a loss will have to be considered for the purpose of allowance according to the provisions of the Act depending upon how the money was utilised by the subscriber."

The CBDT has also subsequently issued instruction to all the Commissioners vide letter dated March 25, 1992 that the existing Instruction No. 1175 on the subject cannot be withdrawn on the basis of the Judgment of the Punjab and Haryana High Court. In a way, the CBDT has upheld the position that in case the amount of chit fund money is utilised for the purposes of business, any loss incurred out of the same is allowable as business expenditure.

10. RELEVANT CASE-LAWS

10. Relevant case-laws in this respect are as under:

10.1 Taxability of Surplus or Allowance of Deduction in the Hands of Subscribers-in *Soda Silicate & Chemical Works vs. CIT*(1989) 179 ITR 588/46 Taxmann 33 (Punj. & Har.), the assessee-firm joined a chit fund and made contributions to it. It secured a chit at a discount of Rs. 14,398 and claimed deduction. The Income-tax Officer disallowed the deduction holding that as it was not the business of the assessee to contribute towards chit funds, the loss incurred was neither incidental to the business nor even remotely related to the business. The AAC allowed the deduction on the ground that as the loan raised from the chit fund was invested in business it was incidental and related to the business of the assessee. When the matter came up before the Tribunal, it was held that contributions to the chit fund could not be treated as revenue expenditure and, similarly, the lump sum received from it, would not be income and, therefore, the dividends too were neither income nor revenue loss. It was observed that 'It is very difficult to imagine that the activity of raising finance by taking a chit from a chit fund can yield any income which can be brought to tax'.

The following question was referred to the High Court for adjudication:

"Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was right in law in disallowing the assessee's claim of loss of Rs. 14,398 in the chit account during the previous year relevant to the assessment year 1980–81?" (p. 590)

The Court held that the contributors had received a lump sum subsequently and there was mutuality amongst contributors and the participants of the chit fund. Hence, contributions made to the chit fund cannot be treated as revenue expenditure nor indeed could the payment and receipt of any amount to and from the chit fund be treated as the business activity of the assessee.

The Court held that the loss claimed by the assessee the chit subscription is not eligible for deduction and, accordingly, the decision was in favour of the revenue. The court held that in *CIT vs. Kovur Textile* (1982) 136 ITR 61 (AP), it did not discuss the aspect of mutuality and, hence, dissented from that decision of the Andhra Pradesh High Court.

In *Kovur Textile's* case (*supra*), it was held that the difference between total instalments paid towards the chit and the amount received as

prize from the chit is eligible for deduction as business loss if the chit money is utilised for business purposes and the chit is a method of funding the business needs of the assessee just like any other borrowing. Similar decision could be found in *ITO vs. Singh Radio Co. (India) (P.)* Ltd. (1991) 59 Taxmann 367 (Delhi) (Mag.) and *Rajees vs. ITO* (1997) 63 ITD 330 (Coch.).

In *Bilahari Investments (P.) Ltd. vs. CIT* ((2007 288 ITR 39 (Mad.), the assessee claimed discount on bidding the chit as expenditure and contended that in the mercantile system of accounting, the expenditure is incurred irrespective of the date of payment and the moment the subscriber becomes a prized subscriber, the expenditure could not be postponed to future years. The assessee claimed that the dividend or kasar is taxable only on the completion of chit whereas the revenue claimed that the dividend or kasar is taxable as and when the chit instalment is due and the discount is deductible proportionately based on the number of instalments completed *vis-a-vis* the number of instalments outstanding.

It is a classic case of assessee and revenue having diametrically opposite view as regards taxation of kasar or dividend and deductibility of discount on bidding the chit.

The court held that the loss arising to the subscriber, *i.e.,* the assessee, must be considered as loss of the relevant accounting year for the purpose of Income-tax assessment. The discount is not an interest payable on the prized amount but it is a loss to the subscriber. The measure of future instalments does not depend on the prize amount or discount nor the discount is an expenditure to be incurred in future. The court held that the discount is not a deferred expenditure for spreading the deduction for the future accounting periods. The court, accordingly, held that the discount is deductible in the year in which it accrues, *i.e.,* upon bidding and is eligible for deduction in wholesome. The dividend was held as taxable on the same basis, *i.e.,* on accrual as and when it accrues to the assessee.

10.2 Dividend on Unsubscribed Chits in the Hands of Chit Company—Taxability*: In CIT vs. Margadarsi Chits Funds (P.) Ltd.* (1985) 155 ITR 442/(1984) 19 Taxmann 73 (AP), the assessee-company was conducting chits among its members. Where chits were prematurely discontinued, the assessee paid instalments till a new subscriber was found, or till the chits expired. Dividends in respect of those chits were credited to 'Accrued Dividends Account' and were paid to new subscribers. The validity of not offering the accrued dividends as income of the assessee and the fact of such practice being followed consistently, was the issue before the court. The court considered the issue as below:

i. The basic question is, whether the assessee has been following an acceptable method of accounting for declaring its income in respect of the defaulting subscribers' chits, and whether the method employed by the assessee is such that correct profits cannot be deduced from the accounts of the assessee and, hence, the provisions of Section 145 of the Income-tax Act could be applied.

ii. The assessee had been following the same system of accounting for its income by way of dividends in respect of the defaulting subscribers' chits for the past several years. The assessee had, therefore, been following a consistent system of accounting and regularly employing the same system of accounting for computing its income from year to year. It was also not in dispute that this system of accounting was not found to be defective by the ITO in the past years.

iii. The ITO gave a fresh look to the matter and felt that the more appropriate system of accounting would be to declare the dividend as and when received as income, and endeavoured to substitute that method of accounting for the method of accounting regularly followed by the assessee.

iv. The choice to account for income on an acceptable basis is that of the assessee, and not of the Department. This is, however, not an unlimited choice, because the ITO has always the liberty to examine the system of accounting regularly employed by the assessee, to determine whether the system of accounting is defective, and whether by following such system of accounting, correct profits can be deduced from the account books maintained by the assessee.

v. In the present case, there was no material to indicate as to why the ITO considered the system of accounting regularly followed by the assessee to be defective, or the system of accounting followed to be such that correct profits could not be deduced therefrom. The ITO's power to substitute a system of accounting for the one followed by the assessee, flows from the provisions of Section 145 of the Income-tax Act.

vi. It is, therefore, imperative that before rejecting the system of accounting followed by the assessee, the ITO must refer to the inherent defect in the system and record a clear finding that the system of accounting followed by the assessee is such that correct profits cannot be deduced from the books of account maintained by the assessee.

vii. The ITO's view that there could be a better system of accounting is no reason for the application of the provisions of Section 145 of the Income-tax Act, especially in view of the fact that this system of accounting was followed by the assessee uniformly and regularly for the past several years, and was accepted by the Department without quarrel. It is not open to the ITO to intervene and substitute a system of accounting different from the one which is followed by the assessee on the ground that the system which commends to the ITO is better.

10.3 Taxability of Commission to Chit Company: *In Shriram Chits (P.) Ltd. vs. Dy. CIT* (83 (2002 ITD 792 (Hyd.-Trib.), the assessee joined the chit group promoted by it as a subscriber and earned dividends. It claimed the dividend as exempt from tax on the principle of mutuality. The court held that 'the principles of mutuality are not applicable to commercial organisation formed with an object of earning profit of commercial nature. It is pertinent to note that we are considering the case of a company which carries on the business of chit funds and not that of an assessee who joins as a subscriber to chits for personal savings or otherwise'. The principle of mutuality cannot be applied to incomes accruing or arising from commercial pursuits. Accordingly, it was held that the income from chit by means of dividend is taxable in the hands of the company though it is the organizer of chits.

10.4 Loss from Chit to the Chit Company—Deductibility: *In Sarvpriya Chits (P.) Ltd. vs. Asstt. CIT* (1997) 60 ITD 674 (Delhi-Trib.), the assessee, a Chit company, claimed Rs. 2.63 lakhs on account of interest loss on chits. The Assessing Officer disallowed the loss on the ground that it was sustained from self-business and does not appear to be reasonable or incidental to the business. The Tribunal held that the shareholders of the company have to participate in the profits of the company and not subscribers of the chits. Hence, the principle of mutuality could not be applied to the assessee which was conducting the chits and the claim of deduction towards interest or loss due to participation in chits was eligible for deduction as business loss.

10.5 Chit Dividend and Section 40(b): *In CIT vs. Devi Finance Corpn.* (215 (1995 ITR 570 (Mad.), the partners of the firm conducting chit business subscribed to chit in their individual or personal capacity. The partners were eligible for dividend similar to other subscribers of the chit. The issue for consideration was whether the

dividend paid to the partners could be disallowed under Section 40(b). The Tribunal held that the chit was conducted by the firm and the partners were the subscribers who got dividend similar to other subscribers and it was not in the nature of interest, remuneration or commission referred to in Section 40(b).

The Court held that the amount paid by the firm as dividend was not out of the commission income earned by the firm. Even if the firm failed to pay dividend to them as subscribers, they were eligible to collect the same from the firm and the Court, hence, held that the dividend paid to partners as subscribers of the chit was not hit by Section 40(b).

10.6 Chit Subscription Written Off as Bad Debt: *In Smt. C. Rajalakshmi vs. ITO* ((1993 47 ITD 315 (Mad.-Trib.), the assessee having subscribed to a chit, wrote off the amount paid as bad debt. The chit company was ordered to be wound up by the Central Government. The claim of deduction was negated by the Assessing Officer as the liquidation proceeding was pending. The Tribunal also declined the claim of the assessee on the reasoning that a debt cannot become bad simply because the insolvency or liquidation proceedings have been commenced on the debtor. However, this decision with the change of law in Section 36(1)(vii) with effect from April 1, 1989 is not applicable in the present day context. Hence, a subscriber to the chit could write-off the chit subscription as bad debt and any recovery subsequently could be subjected to tax under Section 41(4).

10.7 Chit Bidding Whether Lottery Income: *An interesting issue came up in CIT vs. Sanjiv Kumar* (1980) 123 ITR 187/4 Taxmann 97 (Punj. & Har.) in which the assessee claimed income from chit as income from lottery eligible for deduction under Section 80TT. In this case, the amounts paid by the subscribers would be paid by drawing lots and the person eligible for the amount need not make any further contribution to the chit scheme. The Court opined that the receipt as income from lottery was eligible for deduction under Section 80TT (omitted with effect from April 1, 1987).

If the same fact is applied now for taxing a chit having the character of lottery (*i.e.* the bidder is elected by means of lot and he need not pay any further contribution subsequent to winning), then the receipt of the income (amount received less amount paid) would be chargeable to tax as per Section 115BB at the flat rate of 30 per cent and in the event of loss, it is not eligible for deduction or set off against other incomes.

10.8 Chit Run for Funding Charitable Purpose: Where a chit is run to finance a charitable activity, whether the charity would lose exemption from tax, was discussed in *CIT vs. Dharmodayam Co.* (1977) 109 ITR 527 (SC). It was held that the institution being trust for religious or charitable purposes is eligible for the exemption in spite of running the chit for funding the charitable activities.

Presently, Section 11(4A) directly covers such exigencies and if the business is incidental to the attainment of the objects of the trust, the income is exempt in the hands of the trust also and the only condition to be satisfied is maintenance of separate books of account in respect of such business. Also refer *Asstt. CIT vs. Thanthi Trust* (2001) 247 ITR 785/115 Taxmann 126 (SC).

11. NON-BANKING FINANCIAL COMPANIES (NBFCs)

11. In Chapter-6 of Volume-VI of the earlier edition of Investigation Techniques, the NBFCs, their role, functioning including the functioning of several Chit Funds and Chit Fund-like entities were discussed and they would provide valuable inputs in the context of present discussion on chit funds. The relevant extracts of the same are, therefore, reproduced in the following paragraphs.

11.1 Introduction: The term 'NBFC' or non-banking finance company has not been defined either under Income-tax Act, 1961 or the Companies Act 1956. However, these

companies are regulated by the Reserve Bank of India Act, 1934. In 1977, the RBI issued Non-Banking Financial Companies (Reserve Bank) Directions, 1977. However despite these directions early ninetees saw proliferation of thousands of NBFC's, a number of them being fly-by night operators who lured investors with attractive gifts and incentives and vanished with their hard-earned money.

11.2 Upto the year 1996 these finance-companies were regulated by the Reserve Bank Pursuant to the powers given under the RBI Act whereby the Reserve Bank had issued the NBFCs (Reserve Bank) Directions 1977, guidelines on prudential norms in 1994 and various other directions besides clarifications and amendments issued from time to time. However, these guidelines on prudential norms were not compulsory and were to be complied with only; if the NBFC sought relaxation by way of seeking higher limits for deposits/borrowings etc. In 1994 the RBI Act was amended to give more powers and teeth to the RBI for regulating NBFCs. Registration with the RBI was made mandatory for all the NBFCs. As the old directions were considered to be in-adequate, the RBI issued following directions made effective from 2/1/1998.

a. Non-Banking Financial Companies (Reserve Bank), Directions, 1998.
b. Non-Banking Financial Companies Norms (Reserve Bank), Directions, 1998, and
c. Non-Banking Financial Companies (Auditors) Report (Reserve Bank), Directions, 1998.

These regulatory norms of the RBI put restrictions on the tenure of the public deposits and linked the borrowing powers of an NBFC to its credit rating. The new mechanism aimed at a three tier classification of NBFCs not merely for acceptance of public deposits but with shares and investments in their own group of not less than 90% of their total assets. It provided for an interest cap of 16% p.a with a uniform upper ceiling of 2% on brokerage and a limit of 0.5% of deposit in respect of re-imbursement of marketing expenses to brokers.

11.3 For Finance companies seeking to accept public deposits, prudential norms for income recognition, asset-classification, accounting for investments, compliance with accounting standards and guidance notes, provisioning for bad and doubtful debts and capital adequacy were made mandatory. NBFCs were prohibited from lending against their own shares and granting loans or other credit facilities or investments or creating assets in the event of a default in repayment of public deposits so long as such default continues. New directions also prescribed statutory half yearly compliance reports coupled with a greater responsibility on directors and auditors to ensure that operations are strictly in conformity with the RBI directions. RBI also made it clear that advertisements for soliciting public deposits would be transparent and 'statements' by NBFCs to allure gullible would be investors would be restricted. Special reporting by auditors to Non banking finance Companies and Reserve Bank of India was also provided.

Definition of NBFC

11.2.1 A Non-Banking Financial Company has been defined in the RBI Act to mean a company which is a financial institution as defined under Section 45 (I) (c) of the RBI Act, and which has as its principal business:

a. the receiving of deposits, under any scheme or arrangement or in any other manner,
b. or lending in any manner,

11.2.2 RBI may with the prior approval of the Central Government and by notification in the official Gazette specify a company to be a NBFC.

11.2.3 A Non-banking financial company has also been defined in Clause XI of paragraph 2(1) of the NBFC Public Deposit directions, to mean only a non-banking institution which is

a. A Loan Company or
b. An Investment Company or
c. A Hire Purchase Finance Co. or

d. An Equipment Leasing Co. or

e. A Mutual Benefit Financial Company.

f. A company must be a financial institution before the NBFC directions become applicable to it.

11.2.4 Principal Business: The word 'Principal' has been defined in Webster's dictionary as 'Chief' or foremost. The term 'Principal Business' would naturally signify the most important business. The Reserve Bank of India has clarified that classification would be based on the NBFC's principal activity as evidenced from the asset/ income pattern. However, the facts and circumstances of each case are the basic parameters which determine whether business of a company is its principal business or not. Courts have also taken this view. It was observed by the Supreme Court in *Laxminarayan Ramgopal & Sons Ltd. vs. Govt. of Hyderabad* (1954) 25 ITR 449 *(SC)* that when a company is incorporated it may not necessarily come into existence for the purpose of carrying on a business. The objects of an incorporated company/ association are certainly not conclusive of the question whether the activities of the company amount, to carrying on of business'. In the case of *Narain Swadeshi Weaving Mills vs. Commissioner of Excess Profits* (1954 26 ITR 765) business was defined by the Supreme Court as 'some real, substantial and systematic or organised course of activity or conduct with a set purpose'. The Supreme Court has applied following tests to determine what constitutes main or principal or primary business in the case (*CIT vs. Distributors (Baroda) Pvt. LTD*. 83 ITR 377 (SC)).

11.2.5 Regarding the object Clause in the memorandum of association, the Supreme Court observed:

"The objects of the assessee-company are manifold. The object of carrying on the business of 'dealing in or holding of investments' is only one of them. Hence, the memorandum of association does not assist us in deciding whether the business of the assessee-company consists of wholly or mainly in the dealing in or holding of investments".

11.2.6 As regards the profits earned from the various activities the court's observation was as under:

"The investments made by the assessee-company in the shares of the managed-companies are essentially linked with its managing agencies and not with the dealing of that company in shares of the other companies. In other words, those investments form part of the assessee-company's managing agency business activity. If we add the dividend income of shares of the manage companies to the managing agency commission, the total income from those two sources is much more than the income earned by the assessee-company from its share dealings, in each one of the assessment years. Hence, viewed from the point of view of profits earned by the assessee-company, it cannot be said that in the relevant previous years, the assessee company's business ''consisted wholly or mainly in the dealing in or holding of investment".

11.2.7 On the point of assets (tangible and intangible) employed in the various activities the Supreme Court's observation (*CIT vs. Distributors (Baroda) Pvt. Ltd.*) was as under:

''It is true that the asset used by the assessee-company in its share dealing are far more than that used by it for investment in the shares of the managed-company. But then, we have to bear in mind that we do not exhaust the total assets of the company by merely referring to the tangible assets used by it. In addition, we have to take into consideration the value of the managing agencies held by the assessee-company. Looked that way, it cannot be said that the assets of the company, used in its share dealing, are far more than its other assets. At any rate, on the basis of the assets used, it cannot be concluded that the assessee's business consisted 'wholly or mainly' in the dealing in investments"

Therefore, it is critical in determination of the pattern of assets/incomes/ composition over a period of several years besides its primary activity.

11.2.8 Registration with the RBI: A NBFC can commence business after 9th January 1997 or an existing NBFC can carry on the business of a non-banking financial institution only after, obtaining a certificate of registration from the RBI and, having minimum net owned funds of Rs. 25 lakhs. Every non-banking financial company carrying on as its business or as a part of its business any of the following activities will have to get itself compulsorily registered with the RBI.

a. Financing, whether by way of making loans, advances or otherwise of any activity other than its own.

b. Acquiring of shares, stock, bonds, debentures or securities issued by the government or local authority or other marketable securities of a like nature.

c. Letting or delivering of any goods to a hirer under a hire-purchase agreement.

d. Carrying on any class of insurance business.

e. Managing, conducting or supervising as foreman, agent or in any other capacity, of chits or Kuries as defined in any law which is for the time being in force in an state, or any business, which is similar thereto.

f. Collecting, for any purpose or under any scheme or arrangement by whatever name, called, moneys in lump-sum or otherwise, by way of subscriptions or sale of units, or other instruments or in any other manner & awarding prizes or gifts, whether in cash or kind, or disbursing moneys in any other way, to persons from whom moneys are collected or in any other manner.

However, companies carrying on following activities as their principal business are outside the purview of registration:

a. Agricultural operations.

b. Industrial activity as specified in sub Clause (i) to (xviii) of Clause (c) of Section 2 of the IDBI Act, 1964.

c. Purchase or sale of any goods (other than securities) or the provision of any services. Thus even if securities are held as stock-in-trade, registration would be compulsory.

d. Purchase, construction or sale of immovable property.

However, institutions engaged merely in financing the activity of purchase, construction or sale of immovable property by others cannot seek exemption from the requirements of registration under shelter of this Clause.

12. RECOGNITION OF INCOME

12.1 Provisions of para 3 of the NBFC Prudential Norms directions have been substantially amended by the RBI amendments on 12th May 1998. Para 3(1) of the Directions provides that the income is to be recognised on the basis of recognised accounting principles. Para 3(2) of the Directions lays down that income including interest/ discount or any other charges must be recognised only when it is actually realised. Para 3(3) of the Directions deals with the recognition of income in respect of hire-purchase assets where the installments have remained overdue for more than 12 months. In such a case, income should be recognised only when the hire charges are actually received. In respect of lease rent remaining overdue for more than 12 months, income should be recognised only when the lease rent is actually received.

12.2 Determination of Cost of Investment Sold: For tax purposes it is required to follow the Specific Identification method or FIFO method. CBDT circular 704 dated 28/04/1995 requires the cost of investments of the capital assets sold should be determined on the basis of Specific Identification Method. It has been further clarified that in case it is not possible to

follow the Specific Identification Method, the cost of investments sold will be determined on First in First out basis.

13. MUTUAL BENEFIT FINANCIAL COMPANIES

13.1 The NBFC Public Deposit Directions defines a MBFC to mean any company which is financial institution notified as such by the Central Government under Section 620A of the Companies Act, 1956. Under this Section, the Central Government can specify that any provision of the Companies Act will not apply or will apply with such exception, modifications and adaptations as may be specified in the Central Government notification.

13.2 A large number of concerns mainly in South India variously styled as NIDHIs, Mutual Benefit societies, Permanent Funds etc. are incorporated under the Companies Act. Their objects, inter alia, are to enable the members to save money, to invest their savings, and to secure loans at favourable rates of interest. They inculcate the idea of thrift and compulsory savings in the minds of the poor and middle class people. These companies generally have a fixed capital consisting of shares of nominal value. The shares are not offered to the public for subscription but allotted to those who desire to take advantage of the benefits offered for depositing or borrowing money. These companies have transaction only with the members and not with the public at large. They help the members to save money by receiving from them recurring deposits of small sums every month and repaying the accumulated sums at the end of the period, with interest calculated on the amount standing to the credit of the depositor each month. Loans are granted to members on the security of their recurring deposits or of jewels or house property repayable with a moderate rate of interest in monthly installments. For instance, a member who subscribes one rupee every month for a period of seven years gets Rs. 100 at the end of the period. Similarly a member who borrows Rs. 500 on security of his recurring deposit or other security has to pay Rs. 5 every month at the rate of Rs. 1 p.m. for every Rs. 100 of loan and if he continues to pay the same for years, the total amount that he will pay will come to Rs. 420 but the loan of Rs. 500 is automatically discharged at the end of seven years, the difference of Rs. 80 representing the interest contributed with the company on monthly installments of 5 rupees paid by the member.

13.3 Conditions for declaration as NIDHIs or Mutual Benefit Companies-4.3.1 The Department of Company Affairs considers declaration of a company as a Nidhi or Mutual Benefit Society under Section 620A, if the following conditions are complied with:

a. The only object as per the memorandum of association, inter alia, is to inculcate the idea of thrift and savings by members who alone may invest their savings in the company and secure loans, on adequate security. The object Clause may also prohibit carrying on of chit fund, banking, and insurance business.

b. The nominal value of each share does not exceed Rs. 10/-.

c. The minimum number of members of the company is 1000 and not more than 5% of the share capital is held by a single member.

d. The company has carried on business for a period of at least one year and has earned profits.

13.4 Conditions after 20/05/1995 The Central Government has directed that all companies notified under Section 620A after 20/05/1995 must not.

a. Carry on chit funds or insurance or hire-purchase business or business in shares or debentures;

b. Open its branches in addition to the existing branches;

c. Open current accounts with its members;

d. Admit any body corporate as members in its company;

e. Amend its memorandum of association or articles of association without the approval of the Central Government

Further every such company must have:

a. At Least one thousand members w.e.f. 20/10/1997 the minimum number has been increased to at least two thousand members by notification no. GSR 604(E) dated 20/10/1997. However, existing NIDHIs and Mutual Benefit Societies as on 20/10/1997 have been given one year's time from 20/10/1997 to increase the membership from not less than one thousand to not less than two thousand members.

b. Completed at least one financial year.

c. Made a reasonable profit after wiping off all preliminary expenses and brought forward losses.

(Notification F.No. 37/40/94-CL.III dated 28th April, 1995 published in the official gazette, Part II, Section 3(i), page 1170 dated 20th May, 1995. GSR 241 dated 28/04/1995).

The Central Government has issued various notifications from time to time specifying the extent of application of certain Sections of the Companies Act, 1956 to NIDHIs or mutual benefits companies. Reference may be made to pages 2901 to 2903 of Guide to the Companies Act Part II by A. Ramaiya, 13th Edition 1995 for the modification and extent of application of the Sections of the Companies Act, 1956.

13.5 Restrictions on Companies Declared as Mutual Benefit Companies (MBCs): The Department of Company Affairs have issued the following directions to MBCs vide Notification F. No. 3/10/95-CL/V dated 04/12/1995 published in the official Gazette on 04/12/1995:

1. All companies declared a NIDHI or Mutual Benefit Society under Section 620A are prohibited from doing the following with effect from 04/12/1995:

   a. Carry on the business of chit fund, hire purchase, insurance or any business of chit fund, hire purchase, insurance or any business in shares or debentures.

   b. Open any new branch in any place outside the local limits of the District wherein its Registered office is located.

   c. Open any new current account with its members.

   d. Admit any new current accounts with its members.

   e. Issue any new equity shares of nominal value exceeding rupees ten.

   f. Issue any further preference shares (however, w.e.f. 20/10/1997 this prohibition has been withdrawn vide Notification No. GSR 604(E) dated 20/10/1997).

   g. Issue any new shares to any select group of persons other than bona fide depositors.

   h. Acquire control of any other company by way of acquisition of shares, or by composition of the Board of Directors of such company.

   i. Allow use of its name by any other body corporate whose main object is to earn profit by borrowing and lending.

   j. Enter into any financial dealing with any person other than its members.

   k. Take further deposits from or lend further money to any body corporate.

   l. Carry on any business other than the business of borrowing or lending in its own name.

m. Enter into any new partnership arrangement in its borrowing or lending activites.

Give any new loans or advances without the security in the form of fixed deposits or recurring deposits with the said Nidhi or Mutual Benefit Society or gold, silver, jewellery or immovable property.

2. All NIDHIs or Mutual Benefit Societies must with effect from 04/12/1995:

   a. Ensure that its membership is not reduced to less than one thousand members at any time.

   b. Obtain a certificate every year from the statutory auditors certifying that it has complied with the directions specified in the notification dated 04/12/1995 and has maintained its books of account according to recognised principles of accounting.

The NBFC Public Deposit Directions place following restrictions on MBCs:

a. MBCs cannot accept or renew any public deposit except from its shareholders and such deposit must not be in the nature of current account.

b. MBCs cannot pay any brokerage, commission, incentive or any other benefit by whatever name called to any person for public deposits collected by it.

c. MBCs cannot issue advertisement in any form and in any media like billboards, hoardings, newspapers, magazines, television etc. for inviting or causing to invite deposits from its shareholders.

14. RESIDUARY NON-BANKING COMPANIES

14.1 The relevant provisions relating to the residuary banking companies are:

a. Residuary Non-Banking Companies (Reserve Bank) Directions, 1987.

b. Non-Banking Financial Companies and Miscellaneous Non-Banking Companies (Advertisement) Rules, 1977.

Residuary Non-Banking Companies have not been specifically defined under the Residuary Non Banking Companies (Reserve Bank) Directions, 1987. However, by implication, it follows that such companies do not fall into any of the categories mentioned in the NBFC (Reserve Bank) Directions, 1977, Miscellaneous Non Banking Companies (Reserve Bank) Direction, 1977 and Housing Finance Companies (NHB) Directions, 1989. Such Non-Banking Finance Companies (popularly known as Scheme Companies) would be covered by the definition of Residuary Non Banking Companies, if they satisfy the following two conditions:

a. They receive deposits under any scheme or arrangement, by whatever name called in one lump sum or in installments by way of contributions or subscriptions or by sale of units or certificates or other instruments or in any other manner.

b. Such companies do not fall under any of the following categories of companies as defined under the Non Banking Financial Companies (Reserve Bank) Directions, 1977 or the Miscellaneous Non Banking Companies (Reserve Bank) Directions, 1977:

   i. An Equipment Leasing Company

   ii. A Hire Purchase Finance Company

   iii. A Housing Finance Company

   iv. An Insurance Company

   v. An Investment Company

   vi. A Loan Company

   vii. A Mutual Benefit Financial Company and

   viii. A Miscellaneous Non-Banking Company (MNBC)

14.2 Overview: RNBCs are companies which are engaged in activities akin to banking or financial activities and which are not covered under the definition attributed to NBFCs or MNBCs. Such companies are popularly known as "Scheme Companies" since they collect most of their deposits through various schemes which are similar to the recurring deposit schemes run by commercial banks. After the introduction of the Prize Chit and Money Circulation Schemes (Banning) Act, 1978, which sought to prohibit the business of prize chits and money circulation schemes, it was felt that RNBCs would also come within the purview of the said Act. However, in 1987, the Supreme Court ruled that the Scheme run by such companies did not contain any element of prize in it and accordingly they were not hit by the Banking Act. The Supreme Court also directed the RBI to frame appropriate regulations to regulate these companies. Accordingly, the residuary Non Banking Companies (Reserve Bank) Directions, 1987 have been introduced w.e.f. 15th may, 1987, for regulating such companies.

14.3 Residuary Non-Banking Companies (Reserve Bank) Directions 1987—Period of Deposits: RNBCs have been prohibited from accepting deposits which are repayable on demand or on notice. In other words, RNBCs can accept time deposits only. Furthermore, the deposits accepted or renewed by such companies should be for a minimum period of 12 months and a maximum period of 84 months from the date of acceptance or renewal, as the case may be.

a. For the purpose of these Directions, deposits have been assigned the same meaning as given in Section 45-I(bb) of the RBI Act.

b. In case the deposits are received in installments the period of deposit shall be computed from the date of receipt of the first instalment.

14.4 Processing/ Maintenance Charges: RNBCs have been prohibited from collecting any amount towards processing or maintenance charges or any such charges by whatever name called from any depositor/subscriber, with or without his consent, for meeting its revenue expenditure in respect of any scheme run by it. These prohibitions as stipulated in para 4A of the Directions are relaxed only in one circumstance, wherein RNBCs have been permitted to charge new depositors/ subscribers a one time non-refundable sum of Rs. 80/- for meeting expenses on issuing brochures/application forms and servicing the depositors account. The limit of Rs. 80/- is applicable in case the aggregate yearly subscription of such deposit is not less than Rs. 500/-. In case the amount of deposit collected is less than Rs. 500/-, a pro-rata reduction in the said one time non-refundable amount of Rs. 80/- is required to be made.

14.5 Minimum Assured Rate of Return to Depositors: Para 5 of the Directions requires RNBCs to pay the depositors a minimum return of 10% p.a. (to be compounded annually) on the deposits collected by it. The return can be in the form of interest, premium, bonus or it can be in the form of any other advantage. One distinguishing feature in the case of RNBCs is that there is no upper limit fixed for payment of return to depositors unlike that in the case of NBFCs and MNBCs, wherein an interest cap of 16% p.a. and 15% p.a. respectively has been stipulated. In the event of a premature repayment of the deposit at the behest of the depositor (after the expiry of the minimum specified period one year), the rate of return shall be reduced by 2% points below the contracted rate.

15. MISCELLANEOUS NON-BANKING COMPANIES (MNBCs)

15.1 The relevant provisions relating to these companies are:

a. The Chit Funds Act, 1982

b. Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1977.

c. Non-Banking Financial Companies and Miscellaneous Non-banking Companies (Advertisement) Rules, 1977.

15.2 Definition of MNBCs: Para 2 of the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1977 has defined a Miscellaneous Non Banking Company as a financial institution, being a company, which carried on the business of any of the under mentioned activities:

a. In case, the company is carrying on business in the State of Jammu and Kashmir, any of the activities specified in paras 2(1) to (4) of the Directions.

b. In the rest of India, any of the activities, specified in paras 2(2) to (4) of the Directions.

15.3 The activities specified in paras 2(1) to (4) of the Directions are enumerated below:

a. Collecting whether as a promoter, foreman, agent or in any other capacity, moneys in one lump sum or in installments by way of contributions or subscriptions or by sale of units, certificates or other instruments or in any other manner or as membership fees or admission fees or service charges, to or in respect of any savings, mutual benefit, thrift, or any other scheme or arrangement by whatever name called, and utilising the moneys so collected or any part thereof or the income accruing from investment or other use of such moneys for all or any of the following purposes:

   i. Giving or awarding periodically or otherwise to a specified number of subscribers as determined by lot, draw or in any manner, prizes or gifts in cash or kind, whether or not the recipient of the prize or gift is under a liability to make any further payment in respect of such scheme or arrangement;

   ii. Refunding to the subscribers or such of them as have not won any prizes or gift, the whole or part of the subscriptions, contributions or other moneys collected, with or without any bonus, premium, interest or other advantage, howsoever called, on the termination of the scheme or arrangement, or on or after the expiry of the period stipulated therein;

b. Managing, conducting or supervising as a promoter, foreman or agent of any transaction or arrangement by which the company enters into an agreement with a specified number of subscribers that every one of them shall subscribe a certain sum in installments over a definite period and that every one of such subscribers shall in his turn, as determined by lot or by auction or by tender or in such other manner as may be provided for in the agreement, be entitled to the prize amount.

c. Conducting any other form of chit or kuri which is different from the type of business referred to in sub-paragraph (2) above.

d. Undertaking or carrying on or engaging in or executing any other business similar to the business referred to in sub-paragraph (1) to (3) above.

15.4 Overview: MNBCs (popularly known as chit fund companies) are basically engaged in the business of conducting conventional chits. Such companies act as "foreman" and enter into agreements with a specified number of subscribers to the effect that every one of them shall subscribe a certain sum of money by way of periodic installments over a definite period and each subscriber shall in his turn, (as may be determined by lot or by auction or by tender or in such other manner as may be specified in the agreement) be entitled to the prize amount. The prize amount is arrived at by deducting the following from the total amount subscribed at each installments by all subscribers.

a. The commission or service charges charged by the company.

b. The discount, i.e. the sum, if any, which the subscribers agree to forego from out of the total subscription of each instalment, in consideration of the balance being paid to him.

15.5 The Chit Funds Act: The law relating to chit funds is primarily regulated by the Chit Funds Act, 1982. Prior to the introduction of this Central Legislation, certain states framed their own laws in order to regulate chit fund activities in their territories. Section 1(3) of the Chit Funds Act, 1982, states that the provisions of this Act shall come into force on such date as the Central government may by notification in the official gazette appoint and different dates may be appointed for different States. Consequently, the Chit Funds Act, 1982 will become effective in a particular State/ Union Territory only after a notification to that effect has been published in the Official Gazette by the Central Government. MNBCs therefore have to ascertain whether the Central Legislation i.e. the Chit Funds Act, 1982 or the State legislation is applicable to it. The salient provisions of the Chit Funds Act, 1982 are briefly summarised below:

a. (Prior sanction of the State Government (under whose jurisdiction the chit funds business is to be commenced or conducted) is required and the chit funds will have to be registered under the Chit Funds Act prior to commencing or conducting a chit.

b. Any person carrying on the business of chits will be required to use at least one of the words *viz.* Chit, Chit Fund, Chitti or Kuri as a part of its name.

c. The minimum paid up capital of a chit fund company shall be Rs. 11 lakh.

d. Every chit fund agreement is required to be filed with the Registrar by the foreman in duplicate.

e. The foreman shall file a declaration with the Registrar to the effect that all the tickets specified in the chit agreement have been duly subscribed.

f. The aggregate chit amount of the chit conducted by a company shall not exceed 10 times its net owned funds at any point of time.

g. The duration of a chit shall ordinarily not exceed five years. This period can however be extended upto 10 years by the Central Govt.

h. The maximum discount which the prized subscriber shall forego at each instalment shall not exceed 30% of the chit amount.

i. A company carrying on a chit business shall not carry on any other business, except with the general or special permission of the State Govt.

j. Chit fund companies can utilise the moneys collected by them in respect of such business (other than commission or remuneration payable to such person or interest or penalty, if such person or interest or penalty, if any received from a defaulting subscriber) only for the following purposes:

   i. Carrying on a chit business, or

   ii. Giving loans and advances to non-prized subscribers on the security of the subscriptions paid by them, or

   iii. Investing in trust securities within the meaning of Section 20 Indian Trust Act, 1882, or

   iv. Making deposits with approved banks mentioned in the chit agreement.

   v. Every company carrying on a chit business shall create a reserve fund and transfer not less than 10% of its net profits each year prior to declaration of any dividends.

16. TAX INVESTIGATIONS

16.1 Many of the issues for investigation in the cases of NBFCs are the same as are normally

encountered in the cases of the Banks and the Financial Institutions. It may, therefore, be useful to refer to the chapter on assessment of Banks and Financial Institutions while handling a case of NBFC. Some of the common issues discussed in that chapter are:

a. Examination of deposits under Section 68 of the Act.

b. Examination of claims of bad debts as there is likelihood of collusive transactions particularly in respect of the transactions with the utilities connected with the management of such NBFCs.

c. Examination of accounts with a view to examine the fact whether the interest accrued on all advances is accounted for.

d. Loss on revaluation of Securities.

e. Penalty paid to Reserve Bank of India.

f. Broken period interest (BPI).

g. Deduction of expenses incurred for earning tax free income.

h. Interest accrued on investments.

i. Leased assets.

16.2 Claims of Interest: This is one of the important issues for investigation in the cases of the NBFCs. In the cases of practically all the big industrial groups, it is a common practice to float a number of finance and investment companies. Many of such companies are floated to acquire controlling-stakes in the Public Limited Cos. of the group. The issue which arises for investigation in such cases is whether the claim of interest on borrowed funds is an allowable expenditure. This issue will be discussed a little later. In a case of a Finance & Investment Co. of a group it may be found that the assess EE company may not have borrowed any interest bearing fund and may have made investments in the group companies or in some independent companies. Apparently there will be no case for disallowance as no claim towards interest is made in the return. However, if the sources of investments are tracked back to the original source, something significant may be found. In a case it was seen that a company had made investment in the shares of the group companies and the money for purchase of the shares came from issue of Zero Interest Optional Fully Convertible Debentures (ZOIFCD). The issue of debentures was subscribed by a few group companies. In the case of such group company which subscribed to the ZIOFCD also there were no borrowings. Instead that company issued fresh capital which was subscribed by other group companies out of funds borrowed for the purpose of subscribing to the shares of the group companies. Thus in a case like this one or more entities have been introduced in between and the ultimate source of the investment in shares continues to be out of borrowed funds. Such claim of interest in the hands of the ultimate borrower may not be an allowable expenditure. Obviously it maybe necessary for the AO to prove direct nexus between the investments in shares and other securities made by the investment company and the ultimate borrowing by some other company of the group by tracking down the flow of funds.

16.3 As regards the issue relating to allowance to claim of interest in cases where the amounts are borrowed for the purpose of investment of acquiring controlling stakes in the group companies, it has been held in various judgements by the Supreme Court and other courts that the claim of interest relating to investment group companies for acquiring controlling stake is not an allowable expenditure either under Section 36(1) (iii) or Section 57 (iii) of the Indian Income-tax 1961. It has also been held that if the shares or other securities are held as investments and not as stock in trade, the amount of interest paid in relation to the borrowed funds for the purpose will not be an allowable deduction. The judgements make it clear that the fact that the Memorandum of Association (MOA) of a company allows investment, dealing and

trading etc. in shares and other investment does not by itself tantamount to carrying on business of trading in shares by assessee. The Apex Court in the case of *Oriental Investment Ltd. vs. CIT* reported in 32 ITR 664 has held that merely because the assessee company has its objective as dealing in shares, it does not impart it the character of dealer in shares. The SC in the case of *Patiala Biscuits Mfg. (P) Ltd.* as reported in 82 ITR 812 held that despite the fact that the Memorandum of Association allowed investment in shares, the assessee company was not carrying out any organised business of buying and selling and trading in shares. Mere holding of property or investment cannot amount to a business, as held by *Calcutta High Court in East India Prospecting Syndicate vs. CIT,* 19 ITR 571. If an assessee merely disposes of the shares held as investment and earns capital gains, the claim of interest cannot be held as an allowable expenditure under Section 36(1) (iii) of the Income-tax Act.

As regards the question of allowability of expenditure towards interest under Section 57 of the Act, it may be useful to refer to the judgment of the Gujarat High court in the case of *Smt. Virman Ramkrishana vs. CIT,* 131 ITR, 659. The court in that case has laid down following tests to determine whether an expenditure can be allowed as a deduction under Section 57:

a. The expenditure must not be in the nature of capital expenditure or personal expenditure or personal expenditure of the assessee.

b. The expenditure must have been laid out wholly and exclusively for the purpose of making or earning income from other sources.

c. The purpose of making or earning income from other courses must be the sole purpose for which the expenditure must have been incurred, that is to say, the expenditure should not have been incurred for any other purpose or for mixed purpose.

d. The distinction between purpose and motive always be borne in mind, in this connection, what is relevant is the manifest and immediate purpose and not the motive or personal consideration weighing in the mind of the assessee in incurring the expenditure.

The Bombay High Court in *CIT vs. Amritaben R. Shah.* 238 ITR 777 held that in order that an expenditure may be admissible under Section 57 (iii), it is necessary that the primary motive of incurring it is directly to earn income falling under the head "Income from other sources''. Unlike Section 37 which allows deduction of expenditure of expenditure incurred wholly and exclusively for the purposes of business, under Section 57(iii), deduction will not be allowed if the expenditure is not incurred for the purpose of earning income falling under the head "Income from other sources" In a case where, admittedly, shares in a company were purchased by the assessee for the purpose of acquiring controlling interest in the company and not for earning dividend, the expenditure incurred by way of interest on the loan taken by the assessee for the said purpose of earning income by way of dividend. From the nature of transaction, it was clear that expenditure was not for the purpose of earning dividends but for the purpose of acquiring controlling interest in the company, and, therefore, it would not be allowable as a deduction under Section 57(iii). Thus for investigating claim of interest in the case of NBFC, to start with, it is necessary to find out:

a. If the purchases of shares and other securities are shown in the balance sheet as investments,

b. Whether the investments are made in group companies,

c. As to what is the ultimate source of funds used for making investments in shares and securities.'

The detailed finding of fact on the afore mentioned issues will enable the AO to decide

upon the allowability or otherwise of the claim of interest.

16.4 Assessment of Income in the Hands of a Director or the Shareholders: In a case it was found that though the assessee company which was a finance and investment company purchases shares of a number of reputed dividend paying independent companies and earned substantial dividend income from such investments, the funds for investment in shares, as aforesaid, came from the subscription to Zero Interest Optional Fully Convertible Debentures (ZIOFCD). Such debentures were subscribed by group companies. The group company that subscribed to the ZIOFCDs, in turn issued shares which were mainly subscribed by the public limited companies of the group. The company earning dividend income on its investments was closely held by the promoters of the group and as such the dividend income more or less exclusively meant to the promoters. Against the dividend so received the assessee company declared dividend and a deduction under Section 80M was claimed. Since apparently there was no liability on account of interest and the expenses made under other heads were also insignificant the gross amount of dividend declared was claimed as deduction under Section 80M reducing the total income for taxation to a very small fraction of the dividend income earned by the company. This raises two important issues for investigation. Firstly it requires to be seen whether the expenditure on account of interest incurred by other group companies for earning the dividend company for the assessee company can be disallowed in their hands. Secondly, whether it could be held, by lifting the corporate veil, that the so called receipts (dividend declared by the closely held investment company of the group) in the hands of the promoters of the company in fact represented a benefit or perquisite from a public limited company to which the ultimate source of fund is traced within the meaning of the provisions of Section 2(24)(iv) of the Income-tax Act. Irrespective of the question of taxability of dividend income, the enrichment of the promoters of the public limited companies at the cost of the investing public by way of modus operandi discussed above need sustained investigation and the information collected in the process needs to be passed on to the Assessing Officers of the companies who are the ultimate source of the investment and the A.O.s having jurisdiction over the promoters of the group companies.

16.5 Bogus Purchases of Fixed Assets: In the recent past, in a large number of cases it has been found that the companies, particularly the NBFCs, claimed depreciation at the rate of 100 per cent on non-existent energy saving devices or the pollution control equipment. Many of such companies have availed of the VDIS and withdrawn the claims of depreciation and paid tax accordingly. Another related issue which is crucial for investigation is the destination of money shown as having been paid against the bogus purchases of fixed assets, as aforesaid. In many cases it is found that that the purchase consideration shown as paid in such cases, after being routed through a number of bank accounts opened in the fictitious names or in the names of petty employees of the group etc. finally came to the directors or promoters of the company or to their relatives. The Assessing Officer having jurisdiction over the case of the company is often satisfied by disallowing the claim of interest in the case of the company and no further action appears to have been taken in large number of such cases involving staggering amounts. The question which requires consideration is whether the amounts so misappropriated by the promoters can be brought to tax in the hands of the recipients, which in most cases will be the directors of the company. It may not be possible to bring to tax the amounts so misappropriated as business income in the hands of the recipients in view of the judgment of the *Mumbai High Court* (94 ITR 616). In the said judgment it has been held that the gains of theft, dacoity, misappropriation or cheating cannot be

treated as taxable income from any business or commerce.

16.6 The value of any benefit obtained from a company by a director or a person having substantial interest in the company or any relative of the director or such other person can, however, be brought to tax under Section 2(24) of the Income-tax Act (210 ITR 585 (Kar); 224 ITR 162 (Allahabad) etc.). In all such cases it may, however, have to be proved by the AO that the benefit has in fact gone to any of the persons mentioned under Section 2(24) of the Income-tax Act.

17. SOME RECENT BIG TICKET PONZI SCAMS

17.1 The Saradha Group Scam has been a major financial scam and alleged political scandal caused by the collapse of a Ponzi scheme run by Saradha Group, a consortium of over 200 private companies that was believed to be running collective investment schemes popularly referred to as chit funds in Eastern India.

The group collected around Rs. 200 to 300 billion from over 1.7 million depositors before it collapsed in April 2013. In the aftermath of the scandal, the State Government of West Bengal where the Saradha Group and most of its investors were based instituted an inquiry commission to investigate the collapse. The State government also setup a fund of Rs. 5 billion to ensure that low-income investors were not bankrupted.

17.2 The Central Government through the Income-tax Department and Enforcement Directorate launched a multi-agency probe to investigate the Saradha scam and similar Ponzi schemes. In May 2014, the Supreme Court of India, inter-state ramifications, possible international money laundering, serious regulatory failures and alleged political nexus, transferred all investigations into the Saradha scam and other Ponzi schemes to the Central Bureau of Investigation (CBI). Many prominent personalities were arrested for their involvement in the scam. The scam has often been compared to the Sanchayita investment scam, a multi crore rupees scam that occurred in West Bengal in the 1970s, complaints related to which led to the formation of the Prize Chits and Money Circulation Schemes (Banning) Act of 1978.

Background and Modus Operandi

17.3 India has a large, low-income, rural population with limited access to formal banking facilities. This leads to the absence of two major helplines for poorer people-that of placing their money safely in deposits and secondly of being able to borrow money for their needs which may be as simple as buying seeds for the next crop or their children's marriage. The second aim is achieved instead by a web of parallel, informal banking in the form of money lenders (pawn brokers) who have existed in India for a few centuries. At its centre are moneylenders, mostly unregulated, often also wealthy landlords or now politicians, used to charge exorbitant rates of interest. To curb this practice, several Moneylenders Acts were enacted by the *State Governments of India* by the 1950s. However failure to replace the role of moneylenders gave rise to unscrupulous financial operators that operated Ponzi schemes. Some commentators place the blame for these kinds of Ponzi schemes on greed rather than exclusion from formal banking systems.

17.4 However, this does not address the former issue of being able to save their money easily, keep it in safekeeping and invest it so that it grows. While post offices have tried to address this through postal savings banks, people are often lured by Ponzi schemes that promise much higher returns.

17.5 The relatively prosperous rural economy of West Bengal had previously relied on small savings schemes run by the Indian Postal Service. However, low rates of interest in the 1980s and 1990s encouraged the rise of several Ponzi schemes in speculative ventures such as Sanchayita Investments, Overland Investment

Company, Verona Credit and Commercial Investment Company. Together, these scams eliminated close to Rs. 10 billion in investor wealth. Despite a history of Ponzi schemes, the continuing decline in interest rates, lack of financial literacy and investor awareness, political patronage, absence of adequate legal deterrence, and regulatory arbitrage encouraged the growth of similar companies. These companies either raised their funds through legitimate channels such as collective investment schemes, non-convertible debentures and preference shares, or illegitimately through hoax financial instruments such as teak bonds, potato bonds or fictitious ventures in agro-export, construction and manufacturing. As of 2013, 80% of multi-level marketing and finance schemes against which complaints have been received are based in West Bengal, giving the state the title of "Ponzi capital of India". It is estimated that these Ponzi funds have amassed around Rs. 10 trillion from unsuspecting depositors in Eastern India.

Financial Operations

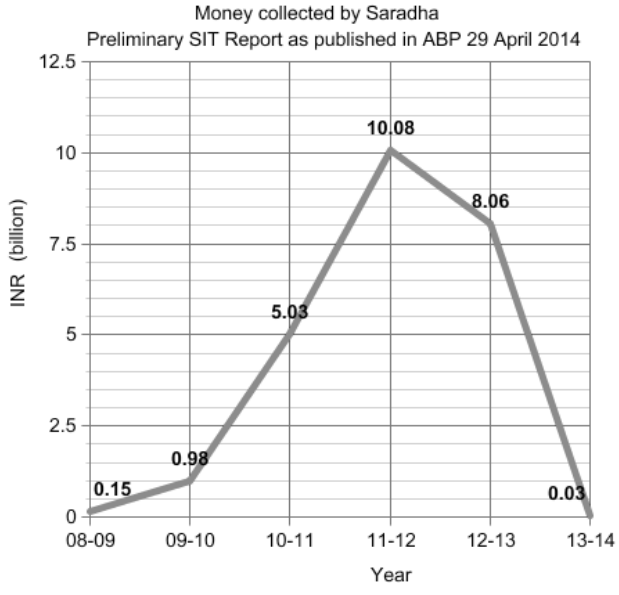


Fig. 1

Money collected by Saradha Group of companies per year in billion INR. 95% of the fund was collected in the last three years of the scam. *(Source: 2014 SIT Report)*

17.6 The companies that were comprised by Saradha Group were incorporated in 2006. Like all Ponzi schemes, Saradha Group promised astronomical returns in fanciful but credible investments. Its funds were sold on commission by agents recruited from local rural communities. Between 25 and 40% of the deposit was returned to these agents as commissions and lucrative gifts to quickly build up a wide agent pyramid. The group used a nexus of companies to launder money and evade regulators.

17.7 Initially, the frontline companies collected money from the public by issuing secured debentures and redeemable preferential bonds. Under Indian Securities regulations and Section 67 of the Indian Companies Act (1956), a company cannot raise capital from more than 50 people without issuing a proper prospectus and balance sheet. Its accounts must be audited and it must also have explicit permission to operate from the market regulator Securities and Exchange Board of India (SEBI).

17.8 SEBI first confronted Saradha Group in 2009. Saradha Group adapted by opening up to 200 new companies to create more cross-holdings. This created an extremely complex tiered corporate structure to confound SEBI by hampering their ability to consolidate blame. SEBI persisted in its investigation through 2010. Saradha Group reacted by changing its methods of raising capital. In West Bengal, Jharkhand, Assam and Chhattisgarh, it began operating variations of collective investment schemes (CIS) involving tourism packages, forward travel and hotel booking timeshare credit transfer, real estate, infrastructure finance, and motorcycle manufacturing. Investors were rarely informed about the true nature of their investments. Instead, many were told they would get high returns after a fixed period. With other investors, the investment was fraudulently sold in the form of a chit fund. Under the Chit Fund Act (1982),

chit funds are regulated by state governments rather than SEBI.

17.9 SEBI warned the state government of West Bengal about Saradha Group's chit fund activities in 2011, again prompting Saradha Group to change its methods. This time, it acquired and sold large numbers of shares of various listed companies then embezzled the proceeds of the sale. By 2012, SEBI was able to classify the group's activities as collective investment schemes rather than chit funds and demanded that it immediately stop operating its investment schemes until it received permission to operate from SEBI. Saradha Group did not comply with this ruling and continued to operate until its collapse in April 2013.

17.10 Like previous Ponzi schemes such as Anubhav teak plantations, Japanlife, and Speakasia, Saradha Group invested heavily in the building of its brand. With enormous funds at its disposal, Saradha invested in high visibility sectors, such as the Bengali film industry, where it recruited actors as its brand ambassador. One renowned bollywood actor was also brought in as the brand ambassador of Saradha Group's media platform.

17.11 The group acquired and established local television channels and newspapers, investing around Rs. 9.88 billion in the media group. By 2013, it employed over 1,500 journalists and owned eight newspapers printed in five languages. It also owned Bengali news channels Tara Newz and Channel 10, Bengali general entertainment channels Tara Muzic and Tara Bangla, Punjabi general entertainment channel Tara Punjabi, an international channel aimed at the Indian diaspora, TV South East Asia and one FM radio station.

17.12 In 2011, Saradha Group bought Global Automobiles, a heavily indebted motorcycle company as a front for the latest version of its Ponzi scheme. Global Automobiles immediately stopped most production but kept 150 workers on its payroll who pretended to work whenever truckloads and busloads of prospective depositors of Saradha Realty visited the plant for a first-hand check before investing. It also bought similar shell companies like West Bengal Awadhoot Agro Private Ltd, located in North 24-Parganas, and Landmark Cement in Bankura to showcase them to agents and depositors and convince them that the Saradha Group had diversified interests.

17.13 As part of its corporate social responsibility program, Saradha Group donated motorcycles to the Kolkata Police. In 2011, it persuaded the West Bengal Government to use its ambulances and motorcycles for the Jangalmahal area of West Midnapore. To further fetch itself in the socio-cultural milieu of Bengal, Saradha Group invested in football rivals and the best-known football clubs in Bengal-Mohun Bagan A.C. (Rs. 18 million in 2010–11) and East Bengal F.C. (Rs. 35 million since 2010). The group also sponsored various Durga Puja celebrations organised by local political leaders. Allegedly several political leaders received financial support from Saradha Group. Some commentators state that this Ponzi scheme survived for so long because of its heavy political patronage.

Collapse

17.14 The earliest public warnings about the reckless and fraudulent CIS in West Bengal started in 2009 from MPs Somendra Nath Mitra and Abu Hasem Khan Choudhury and TMC leader Sadhan Pande. Apart from the SEBI investigation, no executive actions were taken at this time. On 7 December 2012, Reserve Bank of India (RBI) governor said the West Bengal government should initiate suo motu action against companies that were indulging in financial malpractice. By that time, the Saradha Group Ponzi scheme was already beginning to unravel. In January 2013, the group's cash inflow was,

for the first time, less than its cash payouts. This outcome is inevitable in a Ponzi scheme that is allowed to run full course. Sudipto Sen tried but failed to calm uneasy depositors and agents, and could not increase inflow of funds.

17.15 Because most of the Saradha Group depositors came from the lowest economic strata, the loss of the investment would cause a further decrease in social mobility. The scandal drew attention to similar illegal deposit mobilising companies, which are facing increased regulatory pressure. Many of these companies have been variations of time share travel schemes, of which there are few clear regulations. These companies tried to register as cooperative societies to continue their financial operations.

17.16 The Income-tax Department started proceedings against this group in around 2010 and brought to light some startling facts and figures. Four companies of Saradha Group, namely, Saradha Realty India Ltd. (SRIL), Saradha Tours & Travels Pvt. Ltd. (STTPL), Saradha Garden Resorts & Hotel Pvt. Ltd. (SGRHPL) and Saradha Housing Pvt. Ltd. (SHPL) were found to be engaged in money market operations and mobilized funds from public through Collective Incentive Scheme but positioned themselves as real estate/tour operator companies. From Financial Year 2008–09 to April, 2013, the total mobilization of fund were Rs. 2,459 crores. The total liability of the Saradha Group was worked out at Rs. 2,394 crores by Serious Fraud Investigation Office (SFIO), which includes interest of Rs. 411 crores approx. 93% of total collections were in cash.

17.17 In course of Income-tax proceedings, it is revealed that the Saradha Group of companies promoted mainly three types of investment i.e. Fixed Deposit, Recurring Deposit and Monthly Income Scheme. Total approximately 26, 95,286 number of policies were issued under these schemes. Total number of agents were 2,91,518 in 305 branches in total 14 states (pre-dominantly in West Bengal, Assam & Orissa). The payout to collecting agents at the branch level were Rs. 355 crores. The collecting agents were given commission. The operating expenses were almost 28.12% of amount of total collection. Maturity payment was almost 29% of total deposits. There were some other expenses i.e. office expenses, salary etc. In total 53% of total collection were spent for payment of maturity and meeting various expenses. Thus, 47% of the total collection was available to the management for making investment so as to generate surplus to be able to pay the outstanding liability to the investors amounting to Rs. 2,394 crores.

18. ROSE VALLEY CHIT FUND SCAM

18.1 Another prominent Ponzi scheme run by the Rose Valley Group from the state of West Bengal has been accused of duping investors of about Rs. 17,000 crores in different states. The case is being investigated both by the CBI and the Enforcement Directorate (ED), apart from Income-tax proceedings. Rose Valley group owns nearly 23 properties across India and was the business empire was started by Kajal Kundu. Subsequently, Gautam Kundu took over the reins of the company. Gautam was arrested by ED in March 2015. The report added that it was only in 2012 that the company ran into trouble after the IRDAI raised objections. The company had violated RBI guidelines, other related financial fraud control acts.

18.2 It has come to light that Rose Valley had floated a holiday membership plan. The investors were given the choice of opting for a holiday package or 'a return on the investment with annualised interest'. The SEBI, through its probe, found out that the company collected over Rs. 10,000 crore without following due procedures. Moreover, a case was registered

against the company by Assam police, for alleged earning of Rs. 1,006 crore through the scheme until February 2012.

19. GOVERNMENT REACTIONS

19.1 As discussed in the foregoing paragraphs, the illicit deposit taking schemes have become a menace for the socio-economic fabric of the country circumventing the existing regulatory mechanisms. The Twenty-First Report of the Parliamentary Related Standing Committee on Finance (Sixteenth Lok Sabha) titled as *Efficacy of Regulation of Collective Investment Schemes, Chit Funds, etc.* highlighted the regulatory gap. The said Committee in its Report has recommended the requirement of *appropriate legislative provisions, coupled with effective administrative and enforcement measures in order to protect the hard-earned savings and investments made by millions of people.* In line with these recommendations, the Hon'ble Finance Minister in his Budget Speech 2017 mentioned that bill to curtail the menace of illicit deposits will be introduced. He also acknowledged the urgent need to protect the poor and gullible investors from set of dubious schemes, operated by unscrupulous entities who exploit the regulatory gaps. Post this, the *Banning of Unregulated Deposits Scheme Bill* was introduced in Lok Sabha on 18th July 2018. It was referred to the Standing Committee of Finance on 10th August 2018 and was finally passed in Lok Sabha on 13th February 2019. It could not be passed in the Rajya Sabha as the House was not is session. Therefore, it has been introduced as an *Ordinance.*

19.2 Important Sections which are elementary to the law are discussed below:

Section 2 (4)—Definition of Deposit: Deposit is defined in such a manner that deposit takers are restricted from camouflaging public deposits as receipts, and at the same time not to curb or hinder acceptance of money by an establishment in the ordinary course of its business. It includes money received and not commodity.

Section 2 (6)—Definition of Deposit Taker: Deposit Taker includes all possible entities (including individuals) receiving or soliciting deposits, except specific entities such as those incorporated by legislation and banking companies.

Section 2(14)—Definition of Regulated Deposit Scheme Read with First Schedule: Regulated Deposit Schemes ('RDS') are the ones which are permitted to accept and solicit deposits. An exhaustive list of RDS has been specified in the First Schedule to the Ordinance. The list has specified all the present schemes regulated by various regulators for accepting deposits.

Section 2 (17)—Definition of Unregulated Deposit Scheme: This definition is the backbone of the Ordinance. Accordingly, let us first read the entire definition, then break it down and analyse it:

> *(17) "Unregulated Deposit Scheme" means a Scheme or an arrangement under which deposits are accepted or solicited by any deposit taker by way of business and which is not a Regulated Deposit Scheme.*

UDS Means a Scheme or an Arrangement: To qualify as UDS, it should first be a Scheme or an Arrangement. Now what is a Scheme or an Arrangement? Since these are not defined in the Ordinance, let us have a look at its definition in the Oxford's Dictionary.

Scheme: Large-scale systematic plan or arrangement for attaining some particular object or putting a particular idea into effect.

Arrangement: A plan or preparation for a future event.

Under which Deposits are Accepted or Solicited by any Deposit Taker by Way of Business: Deposit taker should accept the deposit by way of business. This is a critical phase which mandates accepting of deposits should be by way of business. Definitions of 'by way of' and 'business' as per Oxford's Dictionary are reproduced below:

> **By Way of:** So as to pass through or across; Constituting; By means of:
>
> **Business:** A person's regular occupation, profession, or trade; Commercial Activity

Therefore, it should be the business of deposit taker of accepting deposits. This means that it should be the regular occupation of deposit taker of accepting-repaying deposits and providing something in return for the same (like an unregistered financial or banking entity). Accepting money for conducting say trading business is not considered as a business of accepting deposits and is hence not considered as UDS. Accepting loans by individuals, firms, etc. for conducting their normal business activities (except financial or banking) are not considered as Unregulated Deposits.

And which is not a RDS

If the scheme is covered under the RDS, it will not be considered as UDS.

Section 3: imposes a blanket ban on UDS. It also bans deposit taker to promote, operate or solicit directly or indirectly any investment in unregulated deposit scheme.

Section 4: prohibits committing fraudulent defaults in repayment of deposit or rendering specified service promised while accepting deposits.

Section 5: prohibits any person other than deposit taker to induce someone to participate in an UDS. Deposit taker is already prohibited for soliciting under Section 3.

Section 7(3): authorizes Competent Authority to provisionally attach the deposit obtained by deposit taker *vide* UDS. It also allows attaching property, if any, acquired out of the deposits accepted.

Section 9: enables the Central Government to designate authority for creating, maintaining and operating an online database for information on deposit takers operating across the country. The present regulators and officers empowered under this law may also be required to share information on deposit takers with the database maintaining authority.

Section 16: authorizes the Court to attach the properties in case the Court is of the view that the deposit taker has transferred the property with a fraudulent intention. Laws of natural justice will be followed while attaching the properties transferred to such *malafide* transferees.

19.3 Applicability: This is a prospective law made applicable from 21st February 2019. It would apply to the whole of India except the State of Jammu and Kashmir. For all the deposits before 21st February 2019, the regulatory framework at that point of time would continue to apply.

19.4 Targeting Unregulated Deposit Schemes: UDS contains a substantive banning Clause which bans Deposit Takers from promoting, operating, issuing advertisements or accepting deposits in any Deposit Taking Scheme which is not regulated. The principle is crystal clear that this Ordinance bans unregulated deposit taking activities altogether, **by making them an offence ex-ante,** rather than the existing legislative-cum-regulatory

framework which only comes into effect ex-post with considerable time lags.

19.5 Prescribed Offences: The Ordinance broadly prescribes three different types of offences and prescribes severe punishment and heavy pecuniary fines for the same. The offences are:

a. Running of Unregulated Deposit Schemes.

b. Wrongful inducement in relation to Unregulated Deposit Schemes.

c. Fraudulent default in Regulated Deposit Schemes.

19.6 Administrative Segment: The Central Government will establish an online database for maintaining records of deposit takers. All the deposit takers pan-India have to provide the information on the database portal regularly. Time and form of reporting has not been prescribed yet. This online portal once made accessible to all, people can verify the genuineness of the deposit takers and substantially reduce the flow of money to illicit deposit schemes. Further, any violation of provisions related to reporting on online database by deposit takers would invite penalty of up to INR 10 Lakh.

19.7 Deposit takers covered under Regulated Deposit Schemes are allowed to accept and solicit for obtaining deposits. However, any fraudulent default in repayment or servicing of deposits would invite fine of higher of INR 5 Lakh; INR 25 Crore; or thrice the amount of profits made on such default. This will be in addition to imprisonment which may extend to 7 years.

Unregulated Deposits have been declared an offence *ex-ante.* In case where unregulated deposits *vide* any schemes are still raised, the law provides for attachment of assets and subsequent realisation of assets for repayment to depositors. Clear-cut time lines have been provided for attachment of property and restitution to depositors.

Major Beneficiaries

a. Poor and gullible people who are being duped by illicit deposit schemes launched by rapacious operators. This law will protect them by altogether banning unregulated deposit taking schemes.

b. Deposit raising entities which are regulated by and accountable to the Government or Regulators, by increasing public faith in them.

20. THE BANNING OF UNREGULATED DEPOSIT SCHEMES ACT, 2019

20.1 The above Ordinance was subsequently replaced by the Banning of Unregulated Deposit Scheme Act, 2019, the Bill for which was introduced in Lok Sabha by the Minister of Finance on July 19, 2019. The Bill provides for a mechanism to ban unregulated deposit schemes and protect the interests of depositors. The said Bill, after having been passed in both Houses of the Parliament, received the ascent of the President on 31st July, 2019 and is deemed to have come into force on the 21st day of February, 2019, as was earlier provided in the Ordinance. In essence, this Bill retains all essential features as contained in the Ordinance. Though at the cost of repetition, some salient feature are discussed below:

a. **Deposit:** The Bill defines a deposit as an amount of money received through an advance, a loan, or in any other form, with a promise to be returned with or without interest. Such deposit may be returned either in cash or as a service, and the time of return may or may not be specified. Further, the Bill defines certain amounts which shall not be included in the definition of deposits such

as amounts received in the form of loans from relatives and contributions towards capital by partners in any partnership firm.

Currently, nine regulators oversee and regulate various deposit-taking schemes. These include: (i) the Reserve Bank of India (RBI), (ii) the Securities and Exchange Board of India (SEBI), (iii) the Ministry of Corporate Affairs, and (iv) State and Union Territory Governments. For example, RBI regulates deposits accepted by non-banking financial companies, SEBI regulates mutual funds, Sate and Union Territory governments regulate chit funds, among others. All deposit-taking schemes are required to be registered with the relevant regulator.

b. **Unregulated Deposit Scheme:** The Bill bans unregulated deposit schemes. A deposit-taking scheme is defined as unregulated if it is taken for a business purpose and is not registered with the regulators listed in the Bill.

c. **Deposit Taker:** The Bill defines deposit takers as an individual, a group of individuals, or a company who asks for (solicits), or receives deposits. Banks and entities incorporated under any other law are not included as deposit takers.

d. **Competent Authority:** The Bill provides for the appointment of one or more government officers, not below the rank of Secretary to the State or Central Government, as the Competent Authority. Police officers receiving information about offences committed under the Bill will report it to the Competent Authority. Further, police officers (not below the rank of an officer-in-charge of a police station) may enter, search and seize any property believed to be connected with an offence under the Bill, with or without a warrant. The Competent Authority may: (i) provisionally attach the property of the deposit taker, as well as all deposits received, (ii) summon and examine any person it considers necessary for the purpose of obtaining evidence, and (iii) order the production of records and evidence. The Competent Authority will have powers similar to those vested in a civil court.

e. **Designated Courts:** The Bill provides for the constitution of one or more Designated Courts in specified areas. This Court will be headed by a judge not below the rank of a district and sessions judge, or additional district and sessions judge.

After provisional attachment of the deposit taker's assets, the Competent Authority will approach the Designated Court to: (i) make the provisional attachment absolute, and (ii) ask for permission to sell the assets. The Competent Authority will have to approach the Court within 30 days (extendable to 60 days). It will also open a bank account to realise and disburse money to depositors under the instructions of the Designated Court.

f. **The Designated Court will have the Power to:** (i) make the provisional attachment absolute, (ii) vary or cancel the provisional attachment, (iii) finalise the list of depositors and their respective dues, and (iv) direct the Competent Authority to sell the property and equitably distribute the money realised among the depositors. The Court will seek to complete the process within 180 days of being approached by the Competent Authority.

g. **Central Database:** The Bill provides for the Central Government to designate an authority to create an online central database for information on deposit takers. All deposit takers will be required to inform the database authority about their business. The Competent Authority will be required to share all information on unregulated deposits with the authority.

h. **Offences and Penalties:** The Bill defines three types of offences, and penalties related to them. These offences are: (i) running (advertising, promoting, operating or accepting money for) unregulated deposit schemes, (ii) fraudulently defaulting on regulated deposit schemes, and (iii) wrongfully inducing depositors to invest in unregulated deposit schemes by willingly falsifying facts. For example, accepting unregulated deposits will be punishable with imprisonment between two and seven years, along with a fine ranging from three to ten lakh rupees. Defaulting in repayment of unregulated deposits will be punishable with imprisonment between three and ten years, and a fine ranging from five lakh rupees to twice the amount collected from depositors. Further, repeated offenders under the Bill will be punishable with imprisonment between five to ten years, along with a fine ranging from Rs ten lakh to five crore rupees. With these few challenges we may face practically, this law is the need of the hour especially in the regions where the investment quantum is enormous in such Ponzi schemes. This may help create a fear in the minds of the people and hence discourage the illegal transactions.

21. CONCLUSION

21.1 In the case of subscribers, the activity of chit subscription is taxable in the case of surplus and deductible as expenditure in the case of deficit. However, if a person does not have any income from business or who does not use chit as a means of financing his business, the deductibility of loss from chit contribution is still debatable. In the case of surplus it is taxable as there is no specific exemption given in the statute.

21.2 A chit subscriber could write-off the amount paid as bad debt as per Section 36(1)(vii) if he does not continue the subscription of chit and reconciles to offer any sum recovered later from chit company as income chargeable to tax as per Section 41(4).

21.3 As regards the chit company, the amount of interest paid for funding the chit activity is deductible as business expenditure. The commission from chit business is chargeable to tax. In the case of any vacancy in the chit and if the chit company pays towards those vacant chits, the dividend in respect thereof could be kept separately to avoid taxability of the same. In the event of any new subscriber joining the chit, the dividend set apart could be given to him. Any portion of such dividend not given to the new subscriber, however, would be taxable in the hands of the chit company.

21.4 The Madras High Court in ***Bilahari Investments (P.) Ltd.'s*** *case* (*supra*) has stated that chit discount is a business loss and not interest. The CBDT Instruction No. 1175 says that the profit from the chit in the hands of subscriber is the extra amount in the nature of interest.

21.5 The nature of activities and functioning of Chit Fund companies, Ponzi Schemes, etc. always pose enormous challenge to the Income-tax authorities in detection of tax evasion. Each case is peculiar to its own facts and has to be tackled quite adroitly by the Assessing Officer. While investigating such cases, the Assessing Officer should make appropriate enquiries into the accounts of the promoters simultaneously with those of the operating firms, corporate entities, etc. The nature and sources of funds should be thoroughly probed into so as to see the applicability of Sections 68/69 and Section 115BBE of the Income-tax Act. The expenditure in the form of huge commission payouts as discussed earlier should be examined in the light of TDS provisions and Sections 37, 69C, etc. There is every possibility that many payments are made in contravention of other laws in force and also such expenditure incurred can be opposed to public policy which would necessitate disallowance under Explanation to Section 37 of the Income-tax Act. Often such unscrupulous entities are found to incur expenditure on making investment in both movable and immovable assets which are bereft of any business purposes, or many such expenses are likely to fall within the ambit of capital expenditure. The Assessing Officer should call for specific details and explanation in such cases.

CHAPTER

4

Foreign Exchange Dealers

1. INTRODUCTION

Authorized money changers are entities, authorized by Reserve Bank under Sec 10 of FEMA, 1999. The objective behind allowing authorized money changers to do business is to widen the access of foreign exchange facilities to residents and tourists while ensuring efficient customer service through competition. No person shall carry on or advertise that he carried on money changing business unless he is in possession of valid money changer's license issued by Reserve Bank. Any person found undertaking money changing business without valid license is liable to be penalized.

2. THERE ARE DIFFERENT TYPES OF AUTHORIZED MONEY CHANGERS WHO ARE

1. Authorised Dealer category I Banks (AD category–I Banks)
2. Authorised Dealer category II (AD's category–II)
3. Full Fledged Money Changers (FFMC)

At present the conversion of currency notes, coins or Traveller's cheques designated in foreign currency into Indian rupees and vice versa is possible with AD I Banks, AD II or FFMC.

Further AD I banks, AD II and FFMCs may appoint franchisees also known as agents to undertake purchase of foreign currency. The objective behind this is to enlarge the network of money changing facility in the country. The franchisees are required to strictly adhere to Know Your Customer/ Anti Money Laundering/ Combating the Financial Terrorism guidelines, as applicable to AD I Banks, AD II or FFMC.

Further, no license for the appointment of franchisee will be issued to any FFMC/Non-banking AD II, against whom any major Directorate of Enforcement/ DRI/ CBI/ Police case is pending.

In case where any FFMC or Non-banking AD II has received one-time approval for appointing franchisee and subsequent to the date of approval any DOE/ DRI/ CBI/ Police case is filed, the FFMC or Non-banking AD II should not appoint any further franchisee and bring the matter to the notice of Reserve Bank immediately.

A decision will be taken by Reserve Bank regarding FFMC or Non-banking AD II to appoint franchisees.

Authorised dealer category II (AD II) can issue forex prepaid card to resident travelling on private business visit abroad subject to Know Your Customer/Anti Money Laundering/ Combating the Financial Terrorism guidelines requirements. However, settlement in respect of forex prepaid card has to be effected through AD category I banks. Forex prepaid card can be used in the same manner as foreign currency notes, traveler-cheque at Duty Free Shops located at international airports in India.

2.1 Table

Sr. No.	Entities	Category	Major Activities
1.	Commercial Banks State Co-op Banks Urban Co-op Banks	Authorised Dealer-Category-I	All current and capital account transactions as per RBI directions issued from time-to-time.
2.	Upgraded FFMCs Co-op. Banks Regional Rural Banks (RRBs) Others	Authorised Dealer-Category-II	Specified non-trade related current account transactions as discussed in Para 2.2, also all the activities permitted to Full Fledged Money Changers. Any other activity as decided by the Reserve Bank.
3.	Select Financial and other Institutions	Authorised Dealer-Category-III	Transactions incidental to the foreign exchange activities undertaken by these institutions.
4.	Dept. of Posts Urban Co-op. Banks Other FFMCs	FFMCs	Purchase of foreign exchange and sale for private and business visits abroad.

Source: RBI/2005-06/314-A.P. (DIR Series) Circular No. 25 A.P. (FL Series) Circular No. 02 Annexure
Note: As we can observe State Co op Banks and Urban Co op Banks are in Category I also and in Category–II also. In most of the cases the treasury branch or the Head Branch of these banks is in the Category–I and other branches are in Category–II or FFMC.

2.2 ADs-Category II will be permitted to release/ remit foreign exchange for the following transactions:

a. Private Visits.
b. Remittance by tour operators/ travel agents to overseas agents/ principals/ hotels.
c. Business Travel.
d. Fee for participation in global conferences and specialized training. Remittance for participation in international events/ competitions (towards training, sponsorship and prize money).
e. Film shooting
f. Medical Treatment abroad.
g. Disbursement of crew wages.
h. Overseas Education.
i. Remittance under educational tie up arrangements with universities abroad.
j. Remittance towards fees for examinations held in India and abroad and additional score sheets for GRE, TOEFL etc.
k. Employment and processing, assessment fees for overseas job applications.
l. Emigration and Emigration Consultancy Fees.
m. Skills/ credential assessment fees for intending migrants.
n. Visa fees.

o. Processing fees for registration of documents as required by the Portuguese/ other Governments.

p. Registration/ Subscription/ Membership fees to International Organizations.

ADs—Category II may also be permitted to undertake additional activities as decided by the Reserve Bank, on case by case basis.

3. BRINGING IN AND TAKING OUT FOREIGN EXCHANGE

3.1 Foreign exchange in any form can be brought into India Freely without limit provided it is declared on the Currency Declaration Form (CDF) on arrival. When foreign exchange brought in the form of currency notes, or travelers cheques does not exceed US $ 10,000 or its equivalent and/or the value of foreign currency notes does not exceed US $ 5,000 or its equivalent, declaration thereof on CDF is not insisted upon.

3.2 Taking out foreign exchange in any form, other than foreign exchange obtained from an authorized dealer or a money changer is, unless it is covered by a general or special permission of Reserve Bank, Non-residents, however have general permission to take out an amount not exceeding the amount originally brought in by them subject to compliance with the above provisions.

4. PURCHASE

4.1 Money-changers may freely purchase foreign currency notes, coins and travelers cheques from residents as well as nonresidents. Production of passport need be insisted upon while encashing traveler's cheques tendered by nonresidents. Where the foreign currency was brought in by declaring on form CDF, the tenderer should be asked to produce the passport. The production of the form may, however be waived if for any reason, the tenderer is unable to produce it. Where CDF is produced, particulars of purchases should be endorsed on the reverse indicating the number and date of encashment certificate under the stamp and signature of the money changer. If the entire amount covered by CDF has been encashed, the form should be retained.

4.2 International Credit Cards: Money changers may sell rupees to foreign tourists against International Credit Cards and take prompt steps to obtain reimbursement through normal banking channels. Thomas Cook is providing this service in India.

4.3 Encashment Certificate: Money changers should issue encashment certificate in form EC in all cases of purchases from the public, irrespective of whether tenderers ask for it or not. These certificates should be issued in the prescribed format of the RBI and serially numbered. A duplicate of each such certificate should be kept on record with the money-changer in book form for production to Reserve Bank as and when called for.

a. Maximum limit: USD 1000 for resident Indian against valid ID and address proof against cash. In excess of this amount should be paid by account payee cheque.

b. Upto Rs 50000 complete details of the Id required however copy is not mandatory.

c. Foreigners and NRI's can encash upto USD 3000 per month against cash on production of Valid Passport.

4.4 Purchases from Other Money-Changers and Authorised Dealers: Money changers may freely purchase from other money changers and authorized dealers any foreign currency notes, coins and encashed travelers cheques tendered by the latter. Rupee equivalent of the amount of foreign exchange purchases should, however be paid only by way of crossed cheque/ Draft.

5. SALES

5.1 Sales to Public under General Authority: Money changers may sell to residents proceeding overseas, foreign currency notes and coins in accordance with the schedule given below. Such sale should not be made earlier than thirty days from the date of departure as evidenced by a confirmed journey ticket, and should be endorsed on the passport.

5.2 Sales Against Basic Travel Quota (BTQ): Money changers may sell exchange in the form of foreign currency notes/coins and travelers cheques to eligible travelers proceeding abroad under the Basic Travel Quota (BTQ) Scheme subject to the conditions given below.

5.3 Eligibility: Resident Indian Citizen for undertaking one or more visits to any country abroad (except Nepal and Bhutan) in any calendar year. Foreign nationals permanently resident in India are also eligible to avail of this quota provided the applicant is not availing of facilities for remittance of his salary etc. abroad in terms of the existing Exchange Control regulations.

5.4 Quantum of Exchange: Upto US $ 250000 or its equivalent per person in a calendar year under LRS (Liberalised remittance scheme) including foreign currency notes, forex prepaid card, traveller's cheque and outward remittance done by an individual.

5.5 Conditions: Passport/ticket of the traveler should be verified to ensure eligibility for release of exchange under BTQ

The sale of foreign exchange should not be made earlier than sixty days from the date of departure recorded on the confirmed journey ticket.

The sale of foreign exchange should be made only on personal application and identification. While issuing traveler's cheques, the conditions for issue stipulated by the issuing company should be scrupulously observed and acknowledgment for receipt of traveler's cheques duly obtained.

Payment in excess of Rs. 50,000 towards sale of foreign exchange should be received only by cheque/Demand Draft. For this purpose sales in installments, should be reckoned as a single withdrawal for the journey.

Sale of foreign currency notes and coins should be restricted upto to US $ 3000 or its equivalent only, per person per trip. However foreign currency notes/coins may be sold to travelers upto their full foreign exchange entitlement for visits to Iraq, Libya, Islamic Republic of Iran, Russian Federation and other Republics of Common Wealth of Independent States and not merely for visits to these countries for transit purpose.

Release of exchange by way of loaded pre-paid cards of banks is yet another permissible mode of carrying foreign exchange and it will be ensured that the technology is not used for money laundering. It will also be ensured that all KYC/AML/CFT guidelines of RBI and the terms and conditions of the Card issuer are fully complied with while issuing prepaid cards and same rigorous standard of due diligence will be applied as in the case of sale of forex either in the form of currency notes and/or traveler's cheque.

5.6 Sales for Business Visits Abroad

5.6.1 Full-fledged money changers may sell exchange in the form of foreign currency notes/ coins and traveler's cheques to eligible travelers in following cases subject to the conditions below:

Business visits sponsored by firms/companies/ organizations in India, journalists deputed on short term assignments abroad by newspapers/ journals and self employed professional like Solicitors, Chartered Accountants undertaking visits abroad in connection with their profession. Exchange may also be released to foreign nationals if the visit is sponsored by the company/firm/organisation in India where they are employed on regular basis.

5.6.2 Documentation-Letter (in duplicate) from the sponsoring firm/company/organisation (from the applicant in cases of self employed professionals) indicating name, address, nationality, passport number of the travelers, duration and nature of visit to each country, exchange required and certifying that the expenses are being borne by them. The payment need to come from the current account of the Indian company sponsoring the business trip.

5.7 Sales Against Reconversion of Indian Currency: Money changers may convert into foreign currency, unspent Indian currency held by nonresidents at the time of their departure from India, provided a valid Encashment Certificate is produced. The supporting certificates should be retained by money-changer for record and verification by Reserve Bank when necessary. Money changers operating at airports/ seaports may convert at their discretion unspent Indian currency upto Rs. 10,000 in the possession of nonresidents/ foreigners at the time of their departure from India if for bona fide reasons, the person is unable to produce Encashment certificate.

5.8 Cash Memo: Money changers should issue on prescribed format to all travelers, to whom foreign currency is sold by them, a cash memo in form CM. The cash memo may be required for production to Customs authorities while taking the foreign currency out of the country. Cash memos should be serially numbered and prepared in duplicate. While the original should be handed over to the traveler concerned, duplicate should be retained for 5 years.

5.9 Rates of Exchange: Money-changers may put through transactions relating to foreign currency notes and traveler's cheques at rates of exchange determined by market conditions.

5.10 Display of Exchange Rate Chart: Money-changers should display at a prominent place in or near the public counter, a chart indicating the rates for purchase/ sale of foreign currency notes and traveler's cheques.

6. REGISTERS MAINTAINED MANDATORILY BY MONEY-CHANGING BUSINESS ENTITIES

6.1 Money changers maintain the following Registers in respect of their money-changing transactions:

FLM (Forex Ledger Maintenance):

FLM 1: Daily Summary and Balance Book (Foreign currency notes/coins) in form FLM 1-(Daily Foreign currency report)

FLM 2: Daily Summary and Balance Book (Traveler's cheques) in form FLM 2– (Daily Traveler's cheque purchase and sale report)

FLM 3: Register of purchases of foreign currencies from the public in form FLM 3 (Encashment details of the passenger)

FLM 4: Register of purchases of foreign currency notes/coins from authorised dealers and authorised money-changers in form FLM 4 (Details of Bulk purchase from ADI, AD II, FFMC and Franchisee)

FLM 5: Register of sales of foreign currency notes/coins and foreign currency traveler's cheques to the public in form FLM 5 (Cash memo details of the passenger).

FLM 6: Register of sales of foreign currency notes/coins to authorized dealers and full-fledged money changers in form FLM 6 (Bulk sale to ADI, AD II, FFMC)

FLM 7: Register of traveler's cheques surrendered to authorized dealers in form FLM 7 (Traveler cheque surrendered to ADI, AD II, FFMC)

FLM 8: Register of monthly sale and purchase return submitting to RBI in form FLM 8

6.2: Submission of Statement to Reserve Bank: Money changers submit to the office of Reserve Bank in whose jurisdiction they are functioning, a monthly statement in form FLM

8 so as to reach Reserve Bank not later than the 10th of the succeeding month.

7. INSPECTION OF TRANSACTIONS OF MONEY-CHANGERS

7.1 FEMA Act empowers any officer of Reserve Bank specially authorized in this behalf to inspect books and accounts and other documents of money changers. Money-changers should give all assistance and cooperation to Inspecting Officers in carrying out their inspection. Failure to produce any books of account or other document or to furnish any statement or information or to answer any question relating to the money-changing transactions to the Inspecting Officers, shall be deemed to be a contravention of the provisions of the Act.

7.2 Under provision of the FEMA Act, deals with powers delegated to private persons of undertaking foreign exchange transactions on behalf of the RBI. Since these transactions are limited mainly to purchase of foreign exchange, that is why these persons are basically known as "Money Changers". Their area of operation and scope of their dealings is very limited, as compared to the Authorized Dealers, which marks the major difference between these two entities. Further in order to regulate the functions of such Authorized Dealers and Money Changers, the RBI from time to time issues various guidelines, which need to be observed in letter and spirit.

7.3 While undertaking various foreign exchange transactions, the Authorized Dealers and Money Changers do commit violations of guidelines issued by the RBI. These violations can be-Technical Violations; or Gross/ serious Violations. So far as technical violations are concerned, these mainly pertain to non-observance of RBI directions with respect to maintenance of various registers etc. e.g. FLM series of registers etc. Since these irregularities in most cases do not involve loss of foreign exchange to the country, these are regarded as merely technical violations. However from the Income-tax angle a lot of useful information relating to tax evasion can be collected from the data available with the FFMC's and AD II. The gross/serious violations committed by such Authorized Dealers/Money Changers result in the loss of valuable foreign exchange to the country.

8. MAJOR IRREGULARITIES BY MONEY CHANGERS/ AUTHORISED DEALERS—CASE STUDIES

8.1 Misuse of BTQ scheme-Under this scheme, foreign exchange of US $ 250000 (or equivalent) is annually released without any specific RBI permit, to any person intending to pay a visit abroad. This foreign exchange can be availed for one or more visits in a year subject to an upper limit of US $ 250000 under LRS. The Authorized Dealers/ Money Changers sometime do not properly verify the documents submitted to them, with the result that the foreign exchange flows into wrong hands and ultimately finds its way into the open market. Money used to purchase foreign Exchange is in many cases out of unaccounted funds which are not declared before the Income-tax Authorities. All such income is liable to the taxed as income from undisclosed sources.

8.2 M/s XYZ was a Full Fledged Money Changer (FFMC) approved by the Reserve Bank of India to purchase foreign currency notes/coins, Traveler's Cheques and to sell foreign currency notes/coins on their own behalf and also to stock and sell foreign currencies & Traveler's Cheques issued by the overseas organizations only upto the specified limited to travelers proceeding abroad under Basic Travel Quota(BTQ)/Business visits. The Enforcement Directorate gathered intelligence that it had been indulging in violations of the Foreign Exchange Management Act (FEMA) by disposing off huge amounts of foreign exchange unauthorized obtained through Forex dealers/companies which were under his control and management.

8.3 An exporter was arrested by the Directorate of Revenue Intelligence (DRI) in connection with

a scam involving misuse of currency declaration forms (CDF), which passengers coming into the country have to fill at airports.

The modus operandi helps unscrupulous exporters in two ways: first, they convert their black money into white; second, they claim government incentives.

Fraudulent, deposited laundered money in foreign exchange. Remittances in foreign exchange were shown to have been received by the exporters. They mention in their CDFs that they have sold goods to some fictitious individuals or companies.

The DRI also arrested people, including textile exporters, for claiming excise duty benefits from the government by showing fake CDFs.

Fraudulent revealed, CDFs were forged/faked at his office by him and the same were submitted to banks for depositing foreign currency into the bank accounts.

This is a unique conspiracy to defraud the government of its legitimate revenues by misusing the benefits of export incentive scheme.

Filling in CDFs is mandatory if the value of foreign currency notes a passenger has exceeds $ 5,000 and if the aggregate of the foreign exchange (in the form of currency notes, bank notes, traveler cheques etc.) with a passenger exceeds $ 10,000.

Modus Operandi

a. Forms were filled by exporters under the name of fictitious passengers travelling to the city to purchase garments from them. The signatures of the customs officials on the forms were forged.

b. These forms were then submitted to banks.

c. The foreign currency declared in the CDF is purchased from the grey market and deposited in the bank account.

d. Fraudsters show the money as earnings from exports.

e. They claim duty benefits for the exported goods from the government.

Investigations revealed that the scam gathered momentum as it was more profitable than the hawala system. Under hawala, money is paid to a middleman in one country who then instructs his associate in another country to pay the final recipient after taking a commission.

While the commission is Rs. 4 per dollar for a hawala transaction, through this CDF fraud it is a mere Rs. 1 per dollar, the investigations have revealed. It has sent out an alert to banks asking them to closely verify deposits of foreign currency.

8.4 In a case before the Enforcement Directorate, the RBI issued a licence dated 01/07/1994 under Section of 7 of the Foreign Exchange Regulation Act, 1973 and authorized M/s XYZ of Bangalore, to purchase and sell foreign currency notes, coins traveler's cheques subject to certain conditions. During the period from October '95 to July '97 the said company M/s XYZ fraudulently released foreign exchange amounting to US $ 1,27,80,490 and US $ 4,46,528 under the Business Visits Schemes and BTQ scheme respectively, in the name of certain persons and handed over the above foreign exchange to Sh. A, a resident of Bangalore.

8.5 The Following Irregularities were Noticed under the Business Visits Schemes (BTS)

a. Passports/ Air tickets were not verified.

b. Signatures of the travelers were not obtained on the TravelersCheques at the time of release/ encashment.

c. Endorsements were not made on the relevant passports indicating the release of foreign exchange.

d. Payments towards foreign exchange were received by means of cheques drawn from the bank accounts of third persons and not from the account of sponsoring firms.

8.6 Irregularities with Reference to the BTQ Scheme

Passports/ Air tickets were not verified.

Signatures of the travelers/ applicants were not obtained on the Traveler's Cheques at the time of release. Documentation were incomplete and not in order in the sense copies of the passports of the travelers were not kept along with the request letters.

In the above manner foreign exchange amounting to US $ 1,32,27,018 was fraudulently released. Apart from the violations of the RBI guidelines and Foreign Exchange Regulation Act, 1973 it has to be seen from the Income-tax angle as to what was the source of the funds used for acquiring the foreign exchange. In fact money was deposited on behalf of various persons who either denied drawing the foreign exchange or fraudulent names were used for withdrawing the foreign exchange. After going through the various documents required and the prescribed forms, the AO can also follow up the investigation from their angle. The forms and procedures with respect to the instructions issued by the RBI to foreign exchange dealers have been mentioned in detail earlier on in this chapter.

8.7 Modus Operandi Regarding Bogus Imports

In this modus-operandi, the importer in India is able to remit precious foreign exchange abroad through banking channels, without having imported any goods or goods of negligible value. Urea Scam involving outflow of foreign exchange of Rs. 133 crores is a glaring example of this modus-operandi.

8.8 Information was received that a group of persons were indulging in arranging illegal remittances in foreign exchange abroad by opening bank accounts in the names of fictitious firms with various banks in Mumbai as also at Surat against submission of bogus import documents to the said banks and that the foreign exchange so remitted was being provided to needy persons outside India against receipt of Indian Currency in India.

8.9 Investigations confirmed the afore-mentioned modus operandi i.e. first bank accounts in the name of bogus firms were opened, with or without the connivance of the bank officials, where after bogus import documents including Bills of Entry, Bills of Lading, Invoices etc. evidencing imports were prepared by them and submitted to the bank along with huge cash amounts being deposited in the concerned bank account, requesting the bank for remitting the equivalent foreign exchange abroad against the so-called imports whereas, in actuality, no goods physically had been imported in India.. In most of the above cases bogus bank accounts were opened and money was deposited in cash in these accounts before being converted into foreign exchange and transferred abroad. The money deposited in these accounts was most likely from unaccounted sources which requires investigation by the Income-tax authorities.

8.10 The foreign exchange received abroad was deposited in certain bank accounts opened there in the name of various firms and thereafter withdrawn and provided to various persons needing it against cash compensatory payments in India including, if necessary, for remitting the foreign exchange to India against certain export-outstanding amounts i.e. against goods exported from India, which in turn, could be bogus i.e., no physical exports could have taken place, and the foreign exchange proceeds so received as export-earnings being eligible for exemption from Income-tax in addition to other export-benefits like duty drawback, import-duty exemptions, import licences etc. Such funds in foreign exchange received abroad are also used for financing purchase of gold abroad for being

brought to India through unauthorized or even authorized channels.

8.11 With the liberalization of policies in the wake of Economic Reforms, various Multinational Companies and NRIs have entered the Indian market, in all fields, as India's market is considered to be the biggest in the world, for consumer and other items, in view of its large population. Though the initial investments of such companies are on non-repatriation basis, but the various facilities enjoyed by them/their staffers including taking out the profits, is likely to cost heavily on the Forex reserves. One case has detected recently (is that of Maple Leaf) where a foreign company registered in New Delhi having invested only Rs. 10 lakhs initially (remitted to India from abroad) was able to take out of India foreign exchange worth crores of Rupees through the Bank, in the garb of profits and salaries of their Directors etc.

8.12 Apart from release of foreign exchange for normal visits, foreign exchange is also released by authorized dealers/money changers to companies/ individuals for meeting medical expenses abroad, participating in trade fairs/ other exhibitions abroad. Many times, the foreign exchange so released is misused or got released on the basis of false documents/claims. These areas are vulnerable and prone to ultimate misuse of foreign exchange which sometimes, are attributable to lack of control over of the authorized dealers/ money changers, and in most cases, their connivance is noticed. These acts lead to violation of FEMA, 1999.

8.13 In one of the nationalized bank Enforcement Directorate busted the fraud involving following modus operandi:

Exploiting Export Schemes: In this, a company or an individual exports goods at an higher price to their own fake companies in order to take benefit of duty drawback scheme of the government. Duty drawback is a refund given by the government to recoup the amount paid by way of custom and excise duties on the raw materials used and service tax on input services used for the manufacture of exported goods. Government uses the duty drawback scheme to promote exports.

Here is an example. Suppose a garment company sells Rs 1,000 worth of shirts for which it used Rs 500 worth of cloth and other materials. The custom duty paid on imports of the cloth or other materials or the excise duty paid on domestic purchases and service taxes paid on all inputs of services will be refunded by the government. If 20 per cent is the tax paid on its raw material, then Rs. 100 (20 per cent of Rs. 500) can be claimed as duty drawback. In this case, dummy companies were opened in Hong Kong. The exporter who had foreign exchange– black money parked abroad, used these entities as clients who send the money back to India to make the transaction look genuine. Government on receiving the foreign exchange disbursed the duty drawback money to the exporter since the entire transaction was closed. The accused traders evaded custom duties, taxes and over-claim duty drawbacks to generate slush funds. ED found that the accused connived in "forming" fake companies and business entities overseas, particularly in Hong Kong by "overvaluing" the export value and subsequently claiming duty drawbacks. Companies route their exports through these fake entities who re-sell the goods at the market price and pad it up with their own money to claim the duty drawback. In the garment example, if the market value of the goods sold is Rs 900, then the dummy company will sell in the market and realize Rs 900 but will send Rs 1000 to its Indian exporter by adding Rs 100 on its own. This mechanism achieves two purposes. One is the unaccounted black money residing abroad comes to India as white money and the exporter also generates extra income by duping the government through its own export incentive schemes.

8.14 In another fraud, where account in nationalized bank and private banks were used for Trade based money laundering Enforcement Directorate and Central Bureau of Investigation

(CBI) investigated the fraud involving following modus operandi:

Advance Remittances for Imports: Nationalized banking its communication to the stock exchanges said that between particular period, 5853 outward foreign remittances of Rs 3,500 crore, mainly for the purpose of 'advance remittances for import' was recorded. Funds were sent through 38 current accounts to various overseas parties numbering to 400, mainly based in Hong Kong and one in UAE. Advance remittances for imports are basically part payment that an importer makes to confirm his imports. Generally, after the initial advance is paid, an exporter sends the remaining amount either on receipt of the goods or after a lag, depending on the negotiation with the seller. Banks on their part have to check if the remaining amount is sent and the goods have landed by confirming it with import documentations. The modus operandi in this transaction was that a number of current accounts were opened particular branch. As per banking system, a remittance of up to $100, 000 does not raise an alarm and is automatically cleared without supporting documents of imports. The money launderers exploited this loophole to pass under the radar. They also smartly selected commodities which are prone to cancellations on account of quality or sharp price fluctuations like fruits, pulses and rice. These commodities were in reality never imported nor any invoices generated that could authenticate the trade. Forged bill of entry was presented to the bank for effecting remittances by the firms. Details of the bill of entry to the bank did not match with the customs import data. The other details like invoice number and details, name of supplier, description of goods, value (in USD) etc were also completely different from customs data. Further, same bill of entry was submitted to different banks and money was remitted against it.

Most of the forex transactions were carried out in newly-opened current accounts wherein heavy cash receipts were observed, but the branch did not raise the red flag and many rules were not followed.

9. SUGGESTIONS/ ADDITIONAL INFORMATION

a. Officer may Cross verify the Bank account payments with Currency Declaration Form (CDF) filled in with Customs. Its mandatory for the Money changer to retain the CDF for 5 years along with other documents such as Passport.

b. Officer may check that Payment in excess of Rs. 50,000 towards sale of foreign exchange should be received only by cheque/ Demand Draft. For this purpose sales in installments, should be reckoned as a single drawal for the journey.

c. Money changer's software at many a times raises the high-risk alert flag in the system for transactions exceeding the limit.

d. Sale of foreign exchange shall take place on application and after identification of the travelers with appropriate documents.

e. While issuing traveler's cheques, the conditions for Issue Company should be scrupulously observed and acknowledgment for receipt of traveler's cheques duly obtained.

f. Money Changer ensures that the traveler is in possession of documents authorizing travel to the countries proposed to be visited as well as ticket for travel to the countries for which exchange has been applied for. The sale of foreign exchange should be made, not earlier than sixty days from the date of departure recorded on the confirmed journey ticket.

g. Sale of foreign currency notes and coins should be restricted upto US$ 3000 or its equivalent only, per person per trip within the travelers' overall foreign exchange entitlement. Additional requirement can be availed by Forex cards or Traveler's cheques. However, foreign currency notes/ coins may be sold to traveler's upto their full foreign exchange entitlement for visits to Islamic Republic of Iran, Russian Federation and other Republics of Commonwealth of Independent States and not merely for visit to these countries for transit purpose.

h. Release of exchange by way of loaded pre-paid cards of banks is yet another permissible mode of carrying foreign exchange and it will be ensured that the technology is not used for money laundering. It will also be ensured that all Know Your Customer/Anti Money Laundering/ CFT guidelines of RBI and the terms and conditions of the Card issuer are fully complied with while issuing prepaid cards and same rigorous standard of due diligence will be applied as in the case of sale of forex either in the form of currency notes and/ or traveler's cheque.

i. RBI guidelines and provision of FEMA 1999, shall be adhered by money changer and requisite record, registers shall be maintained.

j. Officer shall examine that Transactions not pertaining to the money-changing business of the money-changer should not be mixed up with money-changing transactions.

k. Resources for the officers for recent provisions, circulars and amendments to the laws–www.rbi.org

l. Laws covering Money Changers–FEMA, 1999; Prevention of Money Laundering Act, 2012.

CHAPTER

5

Leasing Companies

1. INTRODUCTION

1.1 Lease is a contract. A contract, in the simplest definition, is a promise enforceable by law. The promise may be to do something or to refrain from doing something. The making of a contract requires mutual assent of two or more persons, one of them ordinarily making an offer and another accepting. If one of the parties fails to keep the promise, the other is entitled to legal recourse against him. The Law of Contract recognizes and governs the rights and duties arising from contractual agreements (arrangements). A Lease contract is entered between the owner of a property (the landlord or lessor) and another person (the tenant or lessee) and the lease agreement states the mutually agreed terms of such contract.

2. LEASE

2.1 Definition: 'Lease' is a form of temporary transfer of property. The Draft 'Income Computation and Disclosure Standard' ('ICDS') on 'Leases' of 2015 had proposed to define a lease as an agreement whereby the lessor conveys to the lessee, in return for a payment or series of payments, the right to use an asset for an agreed period of time and was to include a hire purchase agreement also. However, this Draft ICDS has not been notified so far. As such the term 'lease' is not defined in the Income-tax Act, 1961.

2.2 There are other statutory sources where the term 'lease' has been defined. Section 105 of The Transfer of Property Act, 1882 defines the same only in relation to an immovable property as under:

> *"105. Lease defined.—A lease of immoveable property is a transfer of a right to enjoy such property, made for a certain time, express or implied, or in perpetuity, in consideration of a price paid or promised, or of money, a share of crops, service or any other thing of value, to be rendered periodically or on specified occasions to the transferor by the transferee, who accepts the transfer on such terms. Lessor, lessee, premium and rent defined.*
>
> *The transferor is called the lessor, the transferee is called the lessee, the price is called the premium, and the money, share, service or other thing to be so rendered is called the rent".*

2.2.1 The Transfer of Property Act, 1882 also has provisions for duration of such lease, execution of lease, rights and liabilities of the lessor and the lessee, determination of the lease etc. The Registration Act, 1908 and the Indian Stamp Act, 1899 also have provision for registration of leases of immovable property.

2.3 Recently the Ministry of Corporate Affairs (MCA) has notified the Indian Accounting Standards-116 ('Ind AS 116'), which is the new accounting standard for leases. It has been made effective from 1st April 2019 for certain categories of Companies. It has replaced the earlier 'Ind AS 17' on leases. The 'Ind AS 116' defines a lease 'as a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration'. The objective of 'Ind AS 116' is to ensure that the lessees and lessors provide relevant information in a manner that faithfully represents those transactions. Under 'Ind AS 116' the lessees have to recognize a lease liability reflecting future lease payments and a 'right-of-use asset' for almost all lease contracts.

2.4 In assessment proceedings, the lease transactions involve lease of movable properties e.g. machinery, equipments, vehicles etc. Though such lease transactions are not defined under the Income-tax Act, 1961, the concept of lease of movable property is accepted by law and there is no absolute bar to a lease of movable property. Under the Constitution of India, the States have the right to impose tax on the sale or purchase of goods inside the State. The Article 366(29A)(d) of the Constitution defines the tax on the sale or purchase of goods to include a tax on the transfer of the right to use any goods for any purpose (whether or not for a specified period) for cash, deferred payment or other valuable consideration. This provision has the impact of covering lease of movable property also. There are several decisions of the Supreme Court and the High Court wherein the concept of lease of movable property has been explained in terms of the situs of their transfer/ sale under the Sales Tax Laws of various States e.g. *20th Century Finance Corporation Ltd vs. State of Maharashtra* (2000) 6 SCC 12. (Also refer to the Madras High Court decision in the case of *Om Sindhoori Capital Investments Ltd vs. ACIT* in T.C. No. 19 of 2003 dated 28/07/2005 wherein it has been held that the meaning of the word 'lease' as explained in the various decisions of the Supreme Court and High Courts require to be applied). Under the GST, the taxable event is "supply" of goods or services or both and under the CGST Act, 2017, Section 7 covers 'lease' within the meaning and scope of the expression "supply'. Thus, it can be seen that the concept of lease of movable properties is well entrenched in India.

2.5 The Institute of Chartered Accountants of India ('ICAI') also define a 'Lease' in its Accounting Standard ('AS 19') as under:

> *"A lease is an agreement whereby the lessor conveys to the lessee, in return for a payment or series of payments, the right to use an asset for an agreed period of time".*

2.5.1 The 'AS 19' defines and illustrates the concept of 'lease' and various associated terms from the point of view of accounting of such commercial transactions. This definition is different from the definition as given in 'Ind AS116'. Incidentally, the Supreme Court in the case of *CIT vs. Virtual Soft Systems Ltd* (2018) 404 ITR 409 (SC) has applied the Guidance Notes of ICAI and had held that the rule of interpretation says that when internal aid is not available then for the proper interpretation of the Statute, the court may take the help of external aid. If a term is not defined in a Statute then its meaning can be taken as is prevalent in ordinary or commercial parlance.

2.6 Thus, Lease is a contract for the exclusive possession of property for a determinate period of time or at will and for a consideration. The person making the grant is called the lessor, and the person receiving the grant is called the lessee. Two important requirements for a lease

are that the lessee has exclusive possession (non-exclusive possession would be termed a license) and that the lessor's term of interest in the property has to be longer than the term of the lease (a grant involving an equal term or period would comprise a conveyance or assignment, not a lease). A Lease of land can be for perpetuity or for a very long period but this kind of lease is not covered in this chapter.

3. BRIEF BACKGROUND

3.1 The Leasing business activity evolved out of the concept of the old agricultural leasing practices which basically involved granting of a right by the owner in favour of another person for use of the agricultural assets for a certain period in exchange of certain periodic payments (called rentals) with or without payment of a further amount/ premium. Lease benefits both the parties-the owner obtains a return on an asset which otherwise may have remained idle and the user gets an opportunity to generate income out of an asset which either he does not own or has no capacity to buy. Such basic leasing, however, had certain limitations e.g. there was no choice of asset for the user since he had to take the asset ownedby the lessor and in the form it existed or the lessor (owner) was free to take repossess the asset causing a disruption in the activities of the user (lessee) etc.

3.2 The entire concept has since then undergone a change and led to the emergence of concept of 'Lease Financing'. In this scheme the choice of the asset or the make/ model of the asset is left to the user while the cost is financed by the lessor who receives a periodical monetary return from the user. Leasing nowadays basically involve financing the cost of the asset. In India, the first leasing company, 'First Leasing Company of India' was setup in 1973 followed by others. The Industrial Finance Corporation of India and the Industrial Credit and Investment Corporation of India have been into the business of Lease Financing since 1983. The Reserve Bank of India has also permitted Commercial banks and Financial Institutions to offer lease financing.

4. ESSENTIAL INGREDIENTS OF A LEASE

4.1 There are two parties involved in Lease–the lessor and the lessee.

a. **A Lessor is** the personwho is the owner or the title holder of the leased asset or property. The lessor is also the lender and secured party in case of financial leases and operating leases (discussed later in this chapter). In case of leveraged leases, however, a third party (the lender) and not the lessor holds the title.

b. **A Lessee is** the person who is a user or renter of the leased asset or property.

4.1.1 The lessor as well as the lessee may either be an Individual, an AOP a HUF, a firm, a Company, a Financial Institution or a combination of any of the above said two or more categories of persons. Also, there may be lease broker who acts as an intermediary between the lessor and the lessee for certain percentage of fees (like merchant banking division of some banking companies) and there could also be a lease financier to refinance the lessor.

4.2 A Leased Asset is an asset in a lease financing deal and it may be any asset (like plant and machinery or equipment, software, land and building etc.) the ownership of which remains with the lessor and the lessee enjoys the possession and right to use it during the lease term. It is also to be noted that only tangible assets can be leased, the Intangible assets are merely assigned because what cannot be owned cannot be leased. It is also necessary to note that while the lease of a movable property is possible by delivery, the lease of an immovable property has to be by way of a registered document.

4.2.1 The terms related to leased asset are 'Lease Rental', 'lease agreement' and 'lease term'.

4.3 The amount of periodical consideration paid by the lessee to the lessor is known as *Lease rental.* The amount of rental is decided by the lessor after considering:

a. Diminution in the value of the asset over the period of use (in the form of depreciation)

b. Interest on the initial investment and

c. Expenses because of repairs and service charges if borne by the lessor (generally such expenses are borne by the lessee).

4.4 The Inception of the Lease is the earlier of the date of the lease agreement and the date of a commitment by the parties to the principal provisions of the lease.

4.5 The Lease Term is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise. Lease period must be shorter than the economic life of the asset.

4.6 The lease agreement always specifies a *period* during which the lease remains effective. The agreement is *void ab initio* if the period is not mentioned. The lease term may be for the entire period over which the *economic life of asset* spreads or it may be of a shorter period or it may even be perpetual i.e.with an option to renew it from time to time. On expiry of the lease term, the parties may select any of the following courses:

a. The asset will revert to the lessor in which case the lessor either leases it to some other party or may sell the asset to a third party

b. The asset may also be sold to the lessee at some residual value.

4.7 Residual Value of a leased asset is the estimated fair value of the asset at the end of the lease term.

4.8 A Non-cancellable Lease is a lease that is cancellable only:

a. Upon the occurrence of some remote contingency; or

b. With the permission of the lessor; or

c. If the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or

d. Upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

4.9 There are several other terms in use in any lease agreement/ accounting process and they can be referred tofrom the Accounting Standardsissued by the Institute of Chartered Accountants of India.

5. HIRE-PURCHASE

In a lease, asset must be capable of redelivery and if there is no redelivery it becomes a case of hire purchase. Hire-Purchase is a type of lease agreement for the hire of an asset which contains a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed conditions is commonly known as hire purchase agreement. The Hire purchase agreements include covenants under which the property in the asset is to pass to the hirer usually on the payment of the last instalment and the hirer has a right to terminate the agreement at any time before the property so passes. In case of hire-purchase transactions, the hire-vendor pays tax on the income inherent in hire instalments, not on the whole of the hire rentals. Thus, the tax is charged only on the income, and not the inflow. There are no well-defined rules on determination of income in case of hire-purchase transactions, therefore the accounting method prescribed by ICAI or those adopted by the tax payer need to be examined for their suitability. Such methods can be a straight-line, actuarial or rate of return based. A crucial element in such cases is the applicability of the *Departmental Circular No. 9 (R. DIS. NO. 27(4)-IT/43), Dated 23/3/1943* and the point of time where the hire becomes purchase.

6. DISTINCTION BETWEEN A LEASE AND A HIRE-PURCHASE

Essentially, the distinction between a Hire-Purchase and a Lease is based on the beneficial ownership of the asset. In order to qualify for depreciation, the lessor has to establish himself to be both the legal and beneficial owner of the asset. In a true hire-purchase transaction, the lessor allows to the lessee the right to buy the asset at a nominal price and it has to be ascertained from the agreement as to when the lessor has parted with the whole of his beneficial interest in the asset. Usually the lessor will not be able to benefit from the asset during the lease period (as there is a committed right to use to the hirer), and beyond the lease period (as there is a right to buy the asset with the hirer). Having thus permanently divested himself of his beneficial rights, the lessor becomes ineligible to claim depreciation.As it is the beneficial ownership right of the lessor that is crucial, the distinction between lease and hire-purchase goes beyond the mere existence of option to buy in the lease. If, explicitly or implicitly, it is apparent that the lessor has agreed to a permanent beneficial enjoyment of the asset by the lessee, the lease may be treated as a hire-purchase or a plain financing transaction.

7. DIFFERENCE BETWEEN LEASE AND OTHER SIMILAR TRANSACTIONS

Can be tabulated in a summary manner as under:

Attribute	Sale	Lease	License	Service	Bailment
Transfer of title	Yes	No	No	No	No
Reversion of goods	No	Yes	Yes	Yes	Yes
Transfer of possession	Yes	Yes	Yes	No	Yes
Outflow of right to use	Yes	Yes	Yes	No	No
Transfer of control	Yes	Yes	No	No	May be
Passing on benefits of use	Yes	Yes	Yes	Yes	May be

8. TYPES OF LEASE

There are several types of leases, most common among them being:

a. Finance Lease

b. Operating lease

c. Leveraged leases

d. Long-term conveyance Lease.

The brief description of the different types of leases is below:

8.1 Finance Lease

8.1.1 The 'AS19' defines a finance lease as a "a lease that transfers substantially all the risks and rewards incident to ownership of an asset".The title may or may not eventually be transferred. All other kinds of leases are categorized as 'Operating Leases'.

8.1.2 Lease financing companies provide complete funding for the purchase of the capital asset. Unlike other loans, there is no requirement of an immediate down payment of a large amount. Lease financing agreement is easier to negotiate and is free from complex procedures as compared to institutional finance. It involves much less documentation and does not impose any restrictive conditions. The lease rentals are normally structured keeping in view the cash flow of the lessee. The lease term is also selected in consideration of the lessee's capacity and the yield of the asset over its economic life or the lease term. This enables the lessee to start the business with the amount of working capital only. Since

almost the entire fund is available for meeting working capital needs, it is likely to bestow on a lessee competitive advantage over other players in the market. Lease financing also does not dilute the ownership or control of the promoters because of the method of financing. The lease term and rentals are also structured to provide maximum tax benefits to the lessee. In case of lease financing the risk of obsolescence is shifted to the lessor as he is the owner of the asset and the lessee can always request for replacement of the existing model by the latest one. As a method of financing, Finance Lease is cheaper than the alternative courses of borrowing.

8.1.3 The Finance Lease denotes a lease of fixed assets for a certain term where the lessor finances the cost of the asset and transfers the right to enjoy the property along with the risk and the rewards which are incidental to the holding of such asset whether or not the title is eventually transferred to the lessee. Most of the prevailing financing deals come under this category. The scheme envisages payment of rentals by the lessee to the lessor for a certain term including the non-cancelable lease period which is sufficient to recover the investment made by the lessor along with a reasonable profit thereon. Many types of assets including machinery, plant, equipment get leased under this category. The Finance lease is basically a loan in disguise. In the case of finance leases, the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge.

8.1.4 Even as per 'AS19' whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which would normally lead to a lease being classified as a finance lease are:

a. **Transfer of Title:** the lease transfers ownership of the asset to the lessee by the end of the lease term;

b. **Bargain Buyout Option:** the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;

c. **Lease Term Test:** the lease term is for the major part of the economic life of the asset even if title is not transferred;

d. **Present Value Test:** at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

e. **Limited Purpose Asset Test:** the leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

8.1.5 Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

a. if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

b. Gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example in the form of a rent rebate equaling most of the sales proceeds at the end of the lease); and

c. The lessee can continue the lease for a secondary period at a rent which is substantially lower than market rent.

8.1.6 Some very important judgments of the Supreme Court relating to Finance Lease/ Operating Lease are reported as *Asea Brown Boveri Limited vs. Industrial Finance Corporation of India* (2006) 154 Taxmann 512 (SC); Association of Leasing & *Financial Services Companies vs. Union of India & Ors.*

2010-(SC2)-GJX-0838-SC, which can be referred to. The distinction between the two Supreme Court orders above has alsobeen explained by the Special Bench of ITAT in the case titled as *IndusInd Bank Ltd vs. Addl. CIT* (2012) 135 ITD 165 (Mumbai) (SB).

8.2 Operating Lease

8.2.1 An operating lease is a lease other than a finance lease. In an operating lease the lessor does not transfer the asset nor does he recover the full investment along with the profit thereon from a single lease. The lessor provides services attached to the leased asset and recovers the cost for the services provided. An operating lease is basically an economic service. The 'AS 19' mandates that the lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.The lease under this head includes hiring of Computers-with operators, office equipment, automobile, trucks, taxi, Mobile cranes with operators, chartering of aircrafts and ships including provision of crew and fuel etc. Such leases are for a specific period. The lessor bears the risk of obsolescence and incidental risks. There is an option to either party to terminate the lease after giving notice. This kind of lease is preferred where the equipment is likely to suffer obsolescence. In this type of leasing:

a. Lessor bears all expenses.

b. Lessor will not be able to realize the full cost of the asset.

c. Specialized services are provided by the lessor.

8.2.2 The Operating Lease is distinguishable from a Hire Purchase. In Operating Lease, the lessee is allowed to use an asset with the permission of the lessor, for a limited term which is smaller than the economic life of the asset, without the transfer of title, risk and reward. It is more like a rental agreement and the payments made by the lessee are debited to the Profit and Loss Account. The leased asset is returned to the lessor after the expiry of the lease term. There is no security that the lessor would get a full return on the cost of the asset and the same asset can be leased out again to different customer. Such a lease is also easily cancellable. In Hire Purchase the agreement is entered for the transfer of ownership after a fixed term and the customer becomes the legal owner of the asset at the end of the contract. Such Contracts are usually tripartite involving the actual seller, the finance company and the purchaser/ hirer. The lease payments involve repayment of principle as well as interest and only the interest paid gets debited to the Profit and Loss Account.

8.3 Leveraged Leases

8.3.1 The Leveraged Lease is yet another form of lease which is a very complex and sophisticated financing arrangement. A leveraged lease is a lease in which the lessor puts up some of the money required to purchase the asset and borrows the rest from a lender. Usually the lessor puts in 20% to 40% of the funds necessary to buy the equipment and the third-party lender supplies the balance amount. This is called a leveraged lease because the benefits available to the lessor are generally based on the entire equipment cost and since the lessor does not contribute towards the entire cost, its investment is said to be "leveraged" with third-party debt. Generally, the third-party loan is on a nonrecourse-to-the-lessor basis i.e. the repayment to the lender can come only from the lease rentals assigned to it by the lessor. The lessee typically makes payments directly to the lender as the lease payments are assigned to the lender. The repayments to the lender are thus dependent on the regular payments made by the lessee or the lender has a primary right to take back the lessee equipment or has a right over the proceeds coming from the sale or re-release of the lease assets. The lessor has no repayment responsibility even if the lessee defaults and the loan become uncollectible. The actual terms and conditions of the leveraged lease can get modified depending upon the creditworthiness

of the lessee and other economic factors. The leveraged lease involves complex financial structuring and usually a group of lenders come together using a special financial vehicle with detailed rights and obligations of the parties specified therein.

8.3.2 The leveraged lease route is followed in leases involving huge sums of money when the lessor is not able to finance the purchase of the asset fully. The lenders are the major financiers who are assured of a certain return on the fund provided by them to the lessor either in the form of interest or a part of the lease rental. The asset is however mortgaged to the lender. There may be one lease agreement covering all the parties or depending on the situation two agreements- one with the lessor and the financier or lender and the other with the lessor and the lessee.

8.4 Long Term Conveyance Lease

These are long tenure leases which spread over a very long period. This happens mostly in the case of lease in immovable property where lease right extends to a period of 99 years or more.

8.5 Other Lease Nomenclatures

1. **Lease by Manufacturer:** Here, the lessor is also the manufacturer of the leased asset. The asset is leased either directly to the lessee or through an in-house financial company which may purchase the asset and then lease the same to the lessee.
2. **Lease by Supplier or Vendor:** Sometimes the suppliers of equipment (who are not manufacturers themselves) try to boost the sale by having a financial intermediary. This form of leasing is known as Vendor leasing or Sale side leasing. The vendor or the supplier is the lessor under this scheme and the financial intermediary acts as a financier.
3. **Big Ticket or Syndicated Lease:** In many cases, the assets involved in leasing require a large amount of investment like purchase of aircraft, ship etc. As it is almost impossible for one lessor to prove the entire amount for the purchase of such an asset, multiple financiers act as co-lessors sharing the lease rental in proportion to their investments. The lease agreement remains one and the co-lessors and lessee are both a part of this agreement.
4. **International or Cross – Border Leasing:** As opposed to domestic leasing where all the parties to a leasing arrangement belong to the same country, International or Cross border leasing involves parties from different countries who join their hands together in a leasing transaction. A major objective of cross-border tax leases is to reduce the overall cost of financing through utilization by the lessor of tax depreciation allowances to reduce its taxable income. The tax savings are passed through to the lessee as a lower cost of finance. The basic prerequisites are relatively high tax rates in the lessor's jurisdiction, liberal depreciation rules and either very flexible or very formalistic rules governing tax ownership.

However, there is no major difference between leases by Indian lessors and cross-border lessors since the income deemed to accrue and arise in India, even for entities not resident in India, will be taxable here. Income arising out of an asset in India will also be deemed to accrue and arise in Indiaif either the asset or the tax-payer is domiciled in India.The principles for computation of income to be taxed remain the same as in case of resident tax payers.The only significant issue is withholding tax. Any payment to a non-resident requires deduction of tax at source.

9. ACCOUNTING OF LEASING TRANSACTIONS

9.1 The Accounting Standard on 'Leases' ('AS 19'), issued by the Institute of Chartered Accountants of India, came into effect in respect of all assets leased during accounting periods

commencing on or after 01/04/2001. It has specifically superceded its earlier Guidance Note of 1995, which must be kept in mind as there are many case laws based on the earlier Guidance Note. The Accounting Standard ('AS19') issued by the Institute of Chartered Accountants also notes that their accounting standard for lease is not to be used to account for:

a. Lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other mineral rights.

b. Licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

c. Lease agreements to use lands.

9.2 The 'AS19' also cautions that though it applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets, it does not apply to agreements that are contracts for services which do not transfer the right to use assets from one contracting party to the other.

9.3 It is relevant to note that the CBDT has not notified any ICDS for lease and the 'Ind AS 116'issued by the Ministry of Corporate Affairs is more oriented towards presentation of financial statements. The **CBDT Circular No. 10/2017** also admits that at present there is no specific ICDS notified for lease transactions. Therefore, the 'AS 19' issued by the ICAI and the decisions by the Courts shall carry more weight.

10. ACCOUNTING BY LESSEES AND LESSORS IN FINANCE LEASES

(a) Finance Lease in the Books of Lessees

10.1 The Lease Transactions and other events should be accounted for and presented by the assessees in their Final Accounts in accordance with their substance and financial reality and not merely with their legal form. A Finance Lease offers lots of complexities. Such types of leases are required to be taken to the Balance Sheet by the lessees because if they are not reflected in the lessee's balance sheet, the economic resources and the level of obligations of an enterprise are understated, thereby distorting financial ratios. Therefore, a finance lease has to be recognised in the lessee's balance sheet both as an asset and as an obligation to pay future lease payments.

10.2 The 'AS 19' mandates that at the inception of a finance lease, the lessee should recognise the asset and the liability for the future lease payments at the same amounts in the balance sheet. That would also be the starting point of investigation into the nature of the transaction. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease or the present value of the minimum lease payments if the fair value exceeds the present value. The 'AS 19' also lays down the manner of calculation of present value. The 'AS 19' also enjoins that the transactions and other events are accounted for and presented in accordance with their substance and financial reality and not merely with their legal form. While the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, in the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge. In a finance lease, the lease payments are required to be apportioned between the finance charge and the reduction of the outstanding liability. The 'AS 19'also requires adequate disclosures for finance leases in the Balance Sheet.

10.3 The finance lease needs to be verified from the point of view of depreciation claims also. The lease payments require to be bifurcated into interest and return of capital. The depreciation policy for a leased asset should be consistent with that for other depreciable assets

which are owned by the lessee. (The relevant accounting standard for such cases are the 'AS6' (Depreciation Accounting), 'AS 10' (Accounting for Fixed Assets) and'AS 28 (Impairment of Assets)).

(b) Finance Lease in the Books of Lessors

10.4 The lessor also recognizes assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease. Since under a finance lease substantially all the risks and rewards incident to legal ownership are transferred by the lessor, the lease payment receivable is treated by the lessor as repayment of principal and finance income alongwith profit. The finance income should be allocated over the lease term on a systematic and rational basis. The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the net investment of the lessor outstanding in respect of the finance lease. The lease payments relating to the accounting period, excluding costs for services, get reduced from both the principal and the unearned finance income.

10.5 Initial direct costs, such as commissions and legal fees, are often incurred by lessors in connection with negotiating and securing leasing arrangements. For finance leases, these initial direct costs are incurred to produce finance income and are either recognised immediately in the statement of profit and loss or allocated against the finance income over the lease term.

10.6 Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to periods during the lease term to produce a constant periodic rate of interest on the remaining balance of the liability for each period. However, at times the manufacturers or dealers quote very low or no rate of interest in order to attract customers. In such a case a larger portion of the total sale amount would get recognised as sale proceeds at the time of entering into a finance lease.

11. ACCOUNTING IN OPERATING LEASES

11.1 Operating Lease in the Books of Lessees

Lease payments under an operating lease are usually recognised as an expense in the statement of profit and loss on a straight-line basis over the lease term unless facts warrant otherwise.

11.2 Operating Lease in the Books of Lessors

The lessor should include an asset given under operating lease in its Balance Sheet under fixed assets and the lease income from operating leases should be recognized in the statement of *P&L* on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished. Other costs, including depreciation, incurred in earning the lease income are recognised as an expense. Initial direct costs incurred specifically to earn revenues from an operating lease are either deferred and allocated to income over the lease term in proportion to the recognition of rent income or are recognised as an expense in the statement of profit and loss in the period in which they are incurred.

12. 'SALE AND LEASE BACK' TYPE OF LEASING TRANSACTION

In these types of transaction, the party who sells the asset also takes it back on lease from the purchaser. Hence, these transactions are called "sale and lease back transactions". Invariably in such transactions, the seller never physically parts with the asset. Such leasing transactions can be further bifurcated into two categories:

12.1 Where the Seller and Lessee are One and the Same Person

In this case, the seller is also the eventual lessee and the other party involved i.e. the buyer (which

invariably is a finance company) becomes the lessor of the asset when the transaction is complete and the purchased asset is leased back to the original seller.

12.2 Where the Seller, Buyer and the Eventual Lessee are Different Persons

In such transactions, the seller, lessor and lessee are the three distinct entities. In other words, the seller of the asset and the lessee to whom the asset is leased out are not the same party as is the case in the routine sale and lease back transaction. The lessee identifies the supplier, negotiates the prices, installation and delivery schedules of the asset and finally approaches the finance companies to purchase the asset and give the same to it on lease.

12.3 The Sale and Lease back is an extremely popular device of raising funds. The lessee gets the needed finance in consideration for sale of the asset and lessor seeks to claim depreciation expense and earns lease rental (return on capital invested). This is often a tax avoidance device and there were many instances in the past of bogus sale and leasebacks at phenomenal values. The law was amended subsequently to insert a specific provision about sale and leasebacks, which now restricts the amount with reference to which depreciation can be claimed in a sale and leaseback transaction to the written down value in the hands of the seller-lessee. That is, the actual cost of the asset to the lessor will be ignored, and instead, depreciation will be allowed on the seller's depreciated value (refer **Explanation 4A** below Section 43(1) of the Income-tax Act, 1961). This provision is applicable only where the seller is the lessee; in other cases, the fair valuation rule in **Explanation 3** to Section 43 (1) shall continue to apply.

12.4 The Sale and Lease back transactions have also to be examined from the point of view of whether these are Finance lease of Operating lease and dealt with accordingly.

13. TAX AVOIDANCE/ EVASION ISSUES IN LEASE TRANSACTIONS

13.1 Depreciation Claimed on the Transfer of a Bogus or Non-Existent Asset

On some occasions an asset claimed to have been transferred and subsequently leased either to the transferee itself or to any third party is found to be bogus or non-existent. This usually happens due to collusion between the lessees and the suppliers (the last two happen to be same in the case of sale and lease back transactions). They raise fake invoices for a non-existent asset and claim depreciation on the same. There are instances where upon a verification being made it was found that the asset on which the depreciation was claimed was never manufactured by the supplier in question or in some cases the supplier itself was found to be non-existent or was not engaged in manufacturing of that asset at all. If the inquiries are pursued properly and the supplier is questioned, he may even deny having entered into any such transactions in question. In such cases of non-existent asset, the transaction entered into between the lessor and the lessee is just a simple financial transaction by which the lessee manipulates to mobilize funds at a lower rate of interest by passing on the benefit of depreciation to the lessor, for an asset which is never in existence at all. The assessee often tries to produce fake invoices raised by non-existent supplier, false installation certificates from the lessee besides valuation certificates to prove the existence of the assets in such transactions. In some of the cases, the sketchy or dubious nature of the valuation report itself may be sufficient to arouse suspicion in the mind of Assessing Officer about the non-genuine character of such transaction and field inquiries are mandated.

13.2 Over-Invoicing of an Asset: These kinds of dubious transactions were the rage in the 1990s when in order to claim depreciation at a higher rate, the lessor and supplier/ seller of the asset, both would enter into a collusive

transaction whereby the invoice value of the asset is enhanced and shown at a price disproportionate to the market value of the asset. Such transactions are usually resorted to in case of transfer of the used assets. In such cases, supplier of the asset, who may happen to be the first buyer of the asset, is likely to have an invoice at an exaggerated price to enable the lessor to claim higher depreciation. This kind of an arrangement is often seen in Sale and Lease Back Transactions. Prior to the insertion of Explanation 4A to Section 43(1) w.e.f. 01/10/ 1996, the provisions in the Income-tax Act were inadequate to take care of such blatant misuse of the provisions relating to depreciation benefits.

13.3 A Single Asset Leased out to Multiple Lessees

It is also termed as Multiple Financing. The source of finance for acquisition of fixed assets may be own funds, loan funds, lease finance or hire purchase finance or any other mode of financing. Instances exist, in which the assessee uses the same asset as security for obtaining multiple finances, i.e. the asset purchased through term loan, may also be got financed by a Leasing Company, and even through Hire purchase transaction. This is done to finance other activities for which funds are not available from Bank. The AO should therefore, examine allowability of depreciation to the right assessee, and the allowability of interest expenses as revenue expenditure.

In such a case, the depreciation claim is preferred in respect of an asset which happens to be genuine and the value at which it is to be purchased by the assessee is often correctly reflected but the same is sold to more than one party (mostly finance companies) and may also be taken back on lease by the supplier of the said asset. Such transactions result in multiple claims of depreciation on the very same asset. Such a transaction is more difficult to detect as any enquiry regarding the existence of the supplier, price at which the asset is purchased, existence of the lessee as well as asset, beside its value may draw an affirmative response in the favor of the assessee. It was only during action under Section 132, when some of such suppliers/ lessees were also investigated, that it came to light that they used to sell their assets to more than one party and in turn got substantial finances at a very nominal rate of interest. Search action on such persons brought to notice of the department the existence of such documents which suggested that the same asset was sold to more than one person and subsequently taken back on lease by the said entities.

The above scenario may undergo a change in the GST Reconciliation process. Under GST, each person having a GST registration in the supply chain takes part in the process of controlling, collecting GST tax and remitting the amount collected. However, to avoid double taxation and cascading effect of tax, input tax credit is provided as a means to set off tax paid on procurement of raw materials, consumables, goods or services that was used in the manufacturing and supply and sale of goods or services. By using the input tax credit mechanism, businesses are able to achieve neutrality in the incidence of tax and ensure that such input tax element does not enter into the cost of production or cost of supply of goods and services. The reconciliation under Goods & Services Tax is about matching the data filed by the supplier with those of the recipients and recording all the transactions that have taken place during that period. As per this all the taxable supplies made under GST will be matched against all the taxable supplies received by the buyer. The input tax credit of purchase of goods and/ or services will only be available if the details of inward supply filed under GSTR-2 return of buyer matches with the details of outward supplies filed in GSTR-1 of the supplier. This interlinking is done by way of auto-population of data filed in GSTR-1 of supplier into GSTR-2 of the buyer. The Government has setup the GST Network (GSTN) as a web application portal to manage this activity. From

the point of view of Direct Taxes, the Assessing Officer should seek the GSTN data to verify whether the GST on lease invoices are matched or not for further investigation.

13.4 Modus Operandi Adopted to Evade Tax in Sale and Lease Back Transactions

The practice adopted for evading tax sometimes involves selling and leasing back of *bogus or non-existent assets or assets which are not in a usable condition* because of sheer lapse of time and continued use of the asset by the seller over a sizable period. Though such assets are of little utility for the purchaser as well as for the lessee, such transactions are entered at a much higher cost than the intrinsic value of the asset primarily to boost the actual cost of the asset in the hands of the lessor. Certain investigations conducted all over India had revealed that even the very reputed and big finance and leasing companies have resorted to large Sale Tax evasion through such dubious transactions. The manufacturing concerns which are hard pressed for working capital, approach finance and leasing companies seeking loans. The finance and leasing companies generally refuse to finance these concerns; however, they generally make offers which cannot be refused or resisted by the needy manufacturing concerns. Instead of directly financing these companies they insist that the manufacturing concerns make documentation as if they are selling some of their assets particularly assets eligible for 100% depreciation (like pollution control equipment, fluidized bed boilers energy saving devices, gas cylinders, individual energy saving devices, gas cylinders, individual pieces/ parts of machinery of large number each value of less than Rs. 5000). Out of necessity, the needy concerns comply with these demands. For this purpose, they locate a defunct company/ non-existent company, prepare invoices as if they manufacture machinery and raise an invoice on finance and leasing Companies as if they are actually selling the machinery. Further, they make entries in the invoices indicating that the machinery is delivered at the premises of the lessees i.e. manufacturing concerns seeking finance/ loans. They also prepare documents indicating that the machinery was transported to the lessees' premises, installed and commissioned. Finally, they also draw lease agreements indicating that the finance and leasing company is leasing out the said machinery for a monthly/ quarterly rent. Further, the payments made to the bogus concerns are shown as manufacturing and selling machinery by way of account payee cheques. In several instances it has been found that the non-existent/ defunct concerns transfer the above sale proceeds to the alleged lessees. In certain cases, the lessees themselves operated the bank accounts of alleged non-existent/ defunct manufacturers. Further, the alleged lessees, having received the sale proceeds start paying back to the finance and leasing company in the guise of lease rentals. Even though no machinery does exist, the above transaction, basically a finance transaction is shown as lease transaction. As the result the finance and leasing companies get benefited by claiming depreciation on the non-existent assets whereas the alleged lessees get the benefit of finance at much lesser cost. These kinds of transaction can be detected only by verifying the bona fides of the concerns shown as manufacturer and suppliers of the said machinery. In this regard, the Assessing Officers are required to examine the respective lease agreements and the details of the machinery/ equipment being leased. The evidence of use of the leased assets is also required to be verified by comparing the pre-and post-commencement details e.g. electricity and water bills, additional wage bills, raw materials used etc. The examination of the bank accounts of the parties can also provide useful tips. Also, enquiries can be made at the factory premises of the alleged lessees for verifying the existence or otherwise of the said machinery.

13.5 The investigations conducted all over the country in this regardalso revealed another

phenomenon. It has come to light that certain concerns involved in manufacturing as well as export resort to *selling depreciation to finance and leasing companies.* The modus-operandi of these transactions is the same as above except that they retain a portion of the alleged sale transaction for the machinery. These concerns approach the finance and leasing companies offering to sell depreciation in the guise of sale and lease back transactions. These concerns, registered as manufacturers of heavy machinery, fabricate invoices as if they are manufacturing and selling the machinery to the leasing companies. For this purpose, they involve third parties apparently engaged in manufacturing activity. The entire sale consideration is paid to the bogus manufacturing concerns by way of account payee cheques out of which about 80% is paid back to the finance and leasing companies as lease rental deposits. Also, the machinery is shown as leased out to the 3rd party concerns. One more way of camouflaging the transaction and giving it a colour of genuineness is by keeping the deposit with a sister concern and transferring quarterly/ yearly installments periodically. The effect of these transactions is that the finance company that has purchased the machinery would receive back 80% of the amount immediately by way of lease rental deposits adjustable for the lease period of 5 to 8 years depending on the requirement and getting the benefit of depreciation in respect of the entire amount shown as cost of machinery. The alleged manufacturer of the machinery and the brokers involved will retain about 20% for assisting the leasing companies to get the benefit of depreciation.

13.6 Investigations also reveal other phenomena in which the same asset is sold to 5–6 finance companies and is then taken back on lease. When confronted with the evidence like nonexistence of assets, or multiple sale of the same asset, most of such leasing companies come up with an explanation that they were not aware of the non-existence of the assets. They claim the loss as bad debt in the subsequently years to the extent of difference between the amount spent on this transaction and the lease rental deposits received. Apparently, this is not a revenue loss and the allow ability or otherwise should be carefully examined. In respect of all lease transactions where no machinery/ asset exists, the entire transaction may be treated as a finance transaction since the asset does not exist. Accordingly, the depreciation claimed thereon is required to be disallowed. However, the assessee may be eligible to claim a deduction of alleged lease rentals offered as income. Since it is in the nature of finance transaction (and the leasing companies always borrow substantial interest-bearing funds from banks and financial institutions) and interest calculated has to be calculated in the same manner as interest is charged by them on financial transactions and bring the same to tax. Claim of the expenditure involved in the bogus lease to be disallowed as not relatable to business.

13.7 Hire Purchase Finance Transactions Camouflaged as Lease Transactions

It has also been noticed that certain concerns engaged in finance and leasing business have been showing transactions of hire purchase finance as lease transactions. In this method, they are claiming depreciation on the assets that are not owned by them. These companies while advancing moneys to small operators for purchase of trucks/ buses/ vans draw a lease deed and obtain the signatures of the hirers (showing them as lessees). Since most of this small-time truck/ van operators are illiterate and are not assessed to Income-tax, (and also due to the fact that they do not claim depreciation) these leasing companies are able to show these transactions as lease transactions. The modus operandi followed in respect of these transactions is as follows:

As and when a truck operator approaches for finance, they collect margin money and documentation charges. The difference between

the cost of the truck/ van/ bus and the margin money is financed by these companies, charging interest between 13 to 16%, depending on the period of repayment. The principal and the interest thereon are generally collected in equated monthly installments. On payment of the last instalment, the vehicle shown as leased out becomes the property of the alleged lessee. Further, the vehicles are registered in the names of the alleged lessees with endorsement favoring the leasing company. The books of accounts of these leasing companies, particularly lease account ledgers reveal the following details recorded on the top of each individual lessees account:

Lease Account No.

Cost of Asset.

Less: Margin Amount

Amount Financed

@....% for..... Years

Insurance for..... Years

Service charges.....

Total

Recoverable as..... installments of Rs..... Each

It is clear from the above that the alleged lessees have actually purchased the vehicles by availing finance from these concerns and that they have paid interest on the amount financed. It is true that most of these alleged lessees do not claim depreciation since they are not assessed to tax. Further, in a few cases where they are marginal assesses, they can avail the provisions of Section 44 AE of the Income-tax Act and file their returns of income accordingly. In either case, they do not claim the depreciation since it is of no use for them. For ascertaining the truth in respect of these transactions the following enquiries are required to be made:

a. The books of accounts of these leasing companies particularly lease account ledgers are to be examined to ascertain as to how these transactions are recorded in their own books.

b. Enquiries are required to be made with the alleged lessees particularly with a query as to whether they are the real owners of the vehicles or not.

c. The registration certificate (RC books) issued by the Road Transport Authorities and the Insurance documents are to be examined.

d. Wherever the alleged lessees are assessed to tax their assessment records are to be seen.

13.8 Sale and Lease Back Transactions where the Assets are Not Identifiable/ Tangible

It was noticed that certain finance and leasing companies have been found to be engaged in sale and lease back transaction in respect of certain assets which are not clearly identifiable/ tangible like air conditioning systems (ducts, vents and other electrical connections but not central air conditioning plant), electric poles (without identifying them), certain items of machinery embedded in the ground (the transfer of such assets by an invoice without transferring the land), etc. In these types of cases, an asset which is a movable property is not capable of being transferred or identified. Also, the market value of these assets, at the time of the lease transaction is almost impossible to ascertain even though the leasing is a way of business. Further, the legal position on this kind of transaction is not all that clear. These need to be examined properly.

13.9 Tax Implications where Lease is Camouflaged as License or Vice Versa

While lease has been discussed at length in the earlier paragraphs, there is another connected term 'license', which at times can be used to mis-declare the actual transaction relating to immovable properties. The term 'license' has been defined in Section 52 of The Easement Act as under:

"License, defined.—Where one person grants to another, or to a definite number of other persons, a right to do, or continue to do, in or upon the immovable property of the grantor, something which would, in the absence of such right, be unlawful, and such right does not amount to an easement or an interest in the property, the right is called, a license."

The above definition, though given in terms of immovable property, has relevance for the licensed use of Plant & Machinery or equipment also. In the case of *Associated Hotels of India Ltd vs. RN Kapoor,* 1959 AIR 1262 (SC) the Supreme Court has approved of the following propositions to distinguish a lease from a license:

1. To ascertain whether a document creates a licence or lease, the substance of the document must be preferred to the form.
2. The real test is the intention of the parties-whether they intended to create a lease or a licence.
3. If the document creates an interest in the property, it is a lease but, if it only permits another to make use of the property, of which the legal possession continues with the owner, it is a licence.
4. If under the document a party gets exclusive possession of the property, *prima facie*, he is considered to be a tenant; but circumstances may be established which negative the intention to create a lease.

The Supreme Court has further held that if a document gives only a right to use the property in a particular way or under certain terms while it remains in possession and control of the owner thereof, it will be a license. The legal possession, therefore, continues to be with the owner of the property, but the licensee is permitted to make use of the premises for a particular purpose. But for the permission, his occupation would be unlawful. It does not create in his favour any estate or interest in the property.

The above analogy can also be used in case of Plant and Machinery etc. to ascertain whether the transaction is one of lease or license. It should be kept in mind that while license expenses are claimable as revenue expenses, the financial lease payments need to be bifurcated into capital payments and interest outgo.This may have tax implications in respect of depreciation also especially in case of intangibles like software, copyrights, IPRs.

14. LEASE TRANSACTIONS IN JUDICIAL PRONOUNCEMENTS

14.1 In the case of *M.Corp Global (P.) Ltd vs. Commissioner of Income-tax, Ghaziabad* (2009) 309 ITR 434 (SC) the facts were that the assessee was engaged in leasing business and it claimed that on 15/03/1991 it had leased certain bottles to its lessee. However, the lessee had drawn up a sub-lease of its own with one sub-lessee in respect of the same bottles and this agreement was pre-dated on 08/03/1991. The assessee claimed depreciation on value of said bottles but the Assessing Officer having noticed that sub-lease held that transaction was not proved and, accordingly, disallowed assessee's claim of depreciation. This was upheld by the Supreme Court also.

14.2 In the case of *Indian Management Advisors & Leasing Pvt. Ltd vs. Commissioner of Income-tax* (2007) 289 ITR 179 (Delhi) the facts were that the assessee after purchasing soft drink bottles entered into lease agreement with parties and leased out said bottles to them. The assessee claimed 100 per cent depreciation on said bottles. The Tribunal held that transactions between assessee and lessees were not transactions of lease but that of financial arrangements which were given the colour of a lease to claim 100 per cent depreciation and disallowed the assessee's claim. The inquiries in this case had revealed that the lease was executed in advance in respect of bottles which were yet to be manufactured; though period of lease was stated to be three years but neither bottles were recalled by assessee nor lease was renewed, yet bottles became property of lessee even after

three years; lease rent commenced more than one month before manufacturing of bottles. The High Court held that it was clear from conduct of parties that intention of parties was not to lease and the lease agreement executed was a financial arrangement only.

14.3 In the case of *I.C.D.S. Ltd vs. Commissioner of Income-tax, Mysore* (2013) 350 ITR 527 (SC) the facts were that the assessee was engaged in business of hire purchase, leasing and real estate etc. It purchased vehicles from manufacturers and thereupon leased out those vehicles to customers. The assessee's claim for depreciation on said vehicles was rejected on ground that it had merely financed purchase of these assets and was neither owner nor user of these assets. The Hon'ble Court found that it was apparent from records that assessee was exclusive owner of vehicles at all points of time and, in case of default committed by lessee, assessee was empowered to re-possess vehicle. Moreover, at conclusion of leased period, the lessee was obliged to return vehicle to assessee. Since it was also undisputed that assessee was a leasing company and income derived from leasing of vehicles had been assessed as its business income, its claim for depreciation was to be allowed.

14.4 In the case of *Mid East Portfolio Management Ltd. vs. DCIT* (2003) 81 TTJ 0037 (Mumbai)(SB) the Assessee companies claimed to have purchased pollution control equipment and boilers from RSEB and GEB, respectively, both of whom were Electricity Boards, and leased them back to the vendors. It was held that it cannot be imagined that an electricity board would dispose of a part of its running equipment by way of sale. It could never have been the intention of RSEB to allow the equipment to be severed and delivered to the assessee since that would have involved serious disruption in power supply. The lease deed was a mere paper arrangement and a simple finance transaction was put under the garb of lease. The Assessees were not therefore entitled to depreciation allowance claimed in respect of the assets/ equipment leased out to RSEB and GEB.

14.5 In the case of *Gowri Shankar Finance Ltd. vs. CIT* (248 (2001 ITR 0713(Kar) the assessee was engaged in sale of consumer durables on instalmentbasisand was claiming them to be lease transactions. The assessee also claimed depreciation on the goods. It was found that the assessee debited the customer to the extent of entire cost of goods along with interest and recovered the amount in the form of 'lease rent'. Thereafter the ownership in goods wassupposedly passed on to the customer. However, the customers were not required to return the goods to assessee. It was noted thatthe consumer durableswere stock-in-trade in the business of assessee. It was held that the assessee was not entitled to depreciation on such goods. Even otherwise, when the assessee debits the full cost of goods in the account of the customer and the customer becomes indebted to the extent of entire cost along with interest, the 'actual cost' of the asset becomes nil in view of Section 43(1). Therefore, depreciation was not to be allowed to the assessee.

15. POSSIBLE LINES OF INQUIRY

15.1 While examining lease transactions, the AO may verify the following aspects:

i. Lease documents and Terms and Conditions.

ii. Warranty and After Sales Support documents.

iii. Genuineness of the invoices produced.

iv. GSTN return verification.

v. Transportation document verification.

vi. Physical verification of asset (Serial Number and Make/ Model Number etc.)

vii. Commissioning certificate and other evidences of installation of asset.

viii. Wage bills and Staff strength (pre-and post-commencement of operations in case of plant and machinery).

ix. Electricity or water bills (pre-and post-commencement of operations in case of plant and machinery).

x. Genuineness of the concern shown as manufacturing the asset.

xi. Valuation Report of asset.

xii. Reference to Valuation Officer, if deemed fit.

xiii. Verification of the bank accounts of the alleged supplier/ manufacturer with emphasis on movement of amounts received as sale proceeds.

xiv. Verification of Books of accounts of concern which had sold and taken asset back on lease

xv. Insurance Documents, etc.

15.2 In *Mid East Portfolio Management vs. DCIT* (2003) 81 TTJ 0037 (Mumbai)(SB), the ITAT Mumbai has discussed certain relevant factors for finding out the genuineness of a Sale and leaseback transactions as under:

i. Was there an intention to pass the property in equipment to the assessee?

ii. Was the equipment identified/ ascertained with reasonable clarity?

iii. Was the equipment valued, and if so, whether it was bona fide valuation? Was the value inflated? How credible is the report of the valuer, if there is one?

iv. What are the terms of the lease? Is the document more of an arrangement for security for the loan and less of a lease?

v. Is there any parallel or collateral documentation or correspondence or an understanding between the parties which throws doubt on their intention professed by the principal documentation?

vi. What is the conduct of the parties? How transparent has it been?

vii. If the lessee is a public utility undertaking, whether the sale of the equipment would be in conformity with the rationale of its existence and whether it would have an adverse impact on its working?

15.3 While examining assessee's claim of depreciation on the assets leased out, the following issues may also be kept in mind:

i. Whether the impugned asset exists or not, during the relevant previous year.

ii. Whether the asset was owned by assessee or not, during the relevant previous year.

iii. Whether the asset was used by assessee or not, during the relevant previous year.

iv. Whether a transfer, valid in law, has been made.

v. Whether the value of the asset has been correctly shown or whether it has been grossly overstated.

vi. Whether the alleged seller has actually reflected this sale in his books of account (In this connection, one can check whether the alleged seller has paid GST on the sale of the asset).

16. CHECKLIST FOR AOs

The discussion above has already elaborated on the possible lines of inquiry by the AO and has also mentioned the likely steps of any inquiry and investigation in respect of lease transactions. The same may be referred to with appropriate modification as per the facts of the case at hand.

CHAPTER

6

Non-Banking Financial Companies

1. NON-BANKING FINANCIAL COMPANIES (NBFC)

1.1 Introduction

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 and engaged in the business of loans and advances, acquisition of shares/ stocks/ bonds/ debentures/ securities issued by Government or local authority orother marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/ purchase/ construction of immovable property.

A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company).

Further, NBFCs should have financial activity as its principal business. A company which fulfills the following two criteria is registered as NBFC by the Reserve Bank of India (RBI):(i) company's financial assets constitute more than 50 per cent of the total assets and (ii) income from financial assets constitutes more than 50 per cent of the gross income.

The RBI ensures that only companies predominantly engaged in financial activity get registered with it and are regulated and supervised by it. In terms of Section 45-IA of the RBI Act, 1934, NBFCs can commence or carry on business of a non-banking financial institution after obtaining a certificate of registration from RBI and should have a Net Owned Funds of Rs. 2 crore.

1.2 Powers, Supervision and Control of NBFCs by RBI

The Reserve Bank has been given the powers under the RBI Act 1934 to register, lay down policy, issue directions, inspect, regulate, supervise and exercise surveillance over NBFCs that meet the 50–50% criteria of principal business. The Reserve Bank can penalize NBFCs for violating the provisions of the RBI Act or the directions or orders issued by RBI under RBI

Act. The penal action can also result in RBI cancelling the Certificate of Registration issued to the NBFC, or prohibiting them from accepting deposits and alienating their assets or filing a winding up petition. If business is carried on by any entity without registering with RBI, then the Reserve Bank can impose penalty or fine on them or can even prosecute them in a court of law. The list of registered NBFCs is available on the web site of Reserve Bank of India. NBFCs are required to file periodical returns prescribed by RBI and they are grouped under three categories. There are other generic reports to be submitted by all NBFCs as elaborated in Master Circular on Returns to be submitted by NBFCs available on www.rbi.org.in → Notifications → Master Circulars → Non-banking and Circular DNBS (IT) CC.No.02/24/01/191/2015–16 dated July 9, 2015 as available on www.rbi.org.in → Notifications.

1.3 Accounting Framework & Accounting Standards of NBFCs

1.3.1 Accounting Standards prescribed under Companies Act, 2013 to the extent not consistent with RBI directions are to be followed. RBI has prescribed prudential norms for NBFC.

1.3.2 Key Accounting Standards Relevant to NBFCs are: (i) AS 9 deals with Revenue Recognition; finance charges/ EMIs/ Interest (ii)AS 19–Leases (iii) AS 13–Accounting of Investments Applicability of RBI guidelines:

Further, key accounting matters include (i) Income recognition in respect of Non-performing assets (ii) Classification of loan assets–standard/ sub-standard/ doubtful and loss assets (iii) General loan loss provisioning (iv) Statutory reserves.

1.3.3 NBFC Related Specific Disclosures are: (i) Loans and advances related (ii) Concentration of Advances and NPAs (iii) Movement in NPA-NPA purchased/ sold (iv) Restructured accounts disclosure (v) Exposures to real estate and capital market (vi) Securitization and assignment and (vii) Financial asset sold to SC/ RC for asset reconstruction.

1.3.4 Income Computation and Disclosure Standards (ICDS)

Notified under Section 145(2) Sub-Section (1) of Section 145 of the Income-tax Act, 1961, provides that the income chargeable under the head "Profits and Gains of Business or Profession" or "Income from Other Sources" shall, subject to the provisions of Sub-section (2), be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. Central Government notified ICDS vide Notification No. S.O. 892(E) dated 31st March, 2015 with effect from Assessment Year 2016–17 and amendments to certain provisions were made. Further vide Notification No. 87 dated 29th September, 2016 ICDS was made effective from the Assessment Year 2017–18. It is clarified by CBDT that the general provisions of ICDS shall apply to all persons unless there are sector specific provisions contained in the ICDS or the Act. For example, ICDS VIII contains specific provisions for banks and certain financial institutions and Schedule I of the Act contains specific provisions for Insurance business.

1.4 NBFCs: Tax Investigations

1.4.1 Many of the issues for investigation in the cases of NBFCs are the same as are normally encountered in the cases of the Banks and the Financial Institutions. It may, therefore, be useful to refer to the issues relating to the assessment of Banks and Financial Institutions while handling the cases of NBFC. Some of the common issues include:

(i) Examination of Deposits under Section 68, (ii) Examination of claims of bad debts (iii) Examination of accounts with a view to examining the fact whether the interest accrued on all advances is accounted for (iv) Loss on revaluation of Securities (v) Penalty paid to Reserve Bank of India. (vi) Broken period interest (BPI) (vii) Section 14A disallowances (viii) Interest accrued on investments. (ix) Leased assets.

1.4.2 Claim of Transfers to Provisions/ Reserve Funds

Bad debts written off is allowed as deduction under Section 36(1)(vii) of the IT Act. Section 36(1)(viia) provides for deduction of amount transferred to provision for bad and doubtful debts of banks, public financial institutions etc., subject to certain limits and conditions. As per RBI's direction, NBFCs have to create reserve fund and transfer minimum 20% of net profit every year before declaration of dividend. Such claim will be made in *P&L* a/c before arriving at net profit for declaration of dividend. *In Shriram Transport Finance Co. Ltd. vs. ITO* (ITAT, Chennai) 126 TTJ 858 it was held that such transfer is only appropriation of income and cannot be allowed as deduction while computing taxable income. However, with the insertion of "deduction shall be allowed in respect of any provision for bad and doubtful debts made by a non-banking financial company, an amount not exceeding five per cent of the total income (computed before making any deduction under this Clause and Chapter VI-A)" as (viia) (d) to subsection 1 to Section 36, w.e.f. 01/04/2017, deduction of provision for bad and doubtful debts are allowed but quantum restricted as per the new provision. In *Art Leasing Ltd. vs. CIT* (2010) 187 Taxmann 29 (Ker.), it was held that NBFCs are not covered by Section 36(1)(viia) and, therefore, they are not entitled to deduction of any provision created for bad and doubtful debts, even though such provision is created based on guidelines issued by RBI. Considering the fact that NBFCs are also engaged in financial lending to different sectors of society, a deduction at par with Public Financial Institutions, State Financial Corporations and State Industrial Investment Corporations has now been provided to them.

1.4.3 Profit on Sale of Debts

Nowadays, many NBFCs used to sell their debts (loans advanced by them) to other factoring agents/ financial institutions usually called as debt buyers on bilateral buy out basis. As per such agreement, sometimes NBFC may have to provide 2–5% as cash collateral by way of fixed deposits of which lean will be made to debt buyer so that it can be utilised to cover any shortfall in collection of loan in future. Some assesses used to reduce such collateral from profit of such transactions under the pretext that retention period is over. This is an incorrect treatment which does not have any sanction of law and not supported by any accounting standards. Even penalty levied for making such false claim was upheld by the Honorable ITAT, Chennai bench in *DCIT vs. Madurai Micro Finance Ltd.* (157 ITD 918).

1.4.4 Recovery of Bad Debts

NBFCs used to write-off the bad debts in its books of account and claim as deduction under Section 36(1)(vii) while computing taxable income. Since advances made by NBFCs are often backed by securities/ assets, by engaging collection agents, they recover fully/ partly such debts which were written off in books. Even though the same has to be offered as income under Section 41(1) of I.T. Act, 1961 many a time, it is not being done as there is not much tracking mechanism for the Department to detect such transactions. In the case of NBFCs with many branches, it is noticed that parallel bank accounts are operated by each branch people and cash/ cheque so collected from debtors are deposited in such bank accounts. Hence, details of bank accounts of such NBFC can be obtained by 360 degree profiling and verified to see whether such bank accounts are incorporated in the balance sheet. If not, whole of the deposit in such bank accounts will need to be assessed as income under Section 41(1).

1.4.5 Claims of Interest

This is one of the important issues for investigation in the cases of the NBFCs. In many cases of the large industrial groups, it is a common practice to float a number of finance and investment companies. Many of such companies are floated to acquire controlling-stakes in the Public Limited Cos. of the group. The issue which

arises for investigation in such cases is whether the claim of interest on borrowed funds is an allowable expenditure. However, if the sources of investments are tracked to the original source, something significant may be found. One or more entities have been introduced in between and the ultimate source of the investment in shares continues to be out of borrowed funds. Such claim of interest in the hands of the ultimate borrower may not be an allowable expenditure. Obviously, it may be necessary for the AO to prove direct nexus between the investments in shares and other securities made by the investment company and the ultimate borrowing from one of the companies of the group by tracking the flow of funds. In cases where the amounts are borrowed for the purpose of investment of acquiring controlling stakes in the group companies, it has been held in various judgements by the Supreme Court and other courts that the claim of interest relating to investment in group companies for acquiring controlling stake is not an allowable expenditure either under Section 36(1) (iii) or Section 57 (iii) of the Indian Income-tax 1961. It has also been held in a number of judicial pronouncements that if the shares or other securities are held as investments and not as stock in trade, the amount of interest paid in relation to the borrowed funds for the purpose will not be an allowable deduction. The judgements make it clear that the fact that the Memorandum of Association (MOA) of a company allows investment, dealing and trading etc. in shares and other investment does not by itself tantamount to carrying on business of trading in shares by assessee.

As regards the question of allowability of expenditure towards interest under Section 57 of the Act, Courts have laid down that, to allow an expenditure as a deduction under Section 57, the purpose of making or earning income from other sources must be the sole purpose for which the expenditure must have been incurred, that is to say, the expenditure should not have been incurred for any other purpose or for mixed purpose. In cases if it is clear that expenditure was not for the purpose of earning dividends but for the purpose of acquiring controlling interest in the company, then interest would not be allowable as a deduction under Section 57 (iii). Thus, for investigating claim of interest in the case of NBFC, it is necessary to find out as to whether the purchases of shares and other securities are shown in the balance sheet as investments; whether the investments are made in group companies; as to what is the ultimate source of funds used for making investments in shares and securities. The detailed finding of fact on the afore mentioned issues will enable the Assessing Officer to arrive at a conclusion the allowability or otherwise of the claim of interest.

1.4.6 Bogus Purchases of Fixed Assets

In many cases, it has been found that the companies, particularly the NBFCs, claimed depreciation at the rate of 100 Per cent on non-existent energy saving devices or the pollution control equipment. Another related issue which is crucial for investigation is the destination of money shown as having been paid against the bogus purchases of fixed assets, as aforesaid. The question which requires consideration is whether the amounts so misappropriated by the promoters can be brought to tax in the hands of the recipients, which in most cases will be the directors of the company. The value of any benefit obtained from a company by a director or a person having substantial interest in the company or any relative of the director or such other person can, however, be brought to tax under Section 2(24) of the Income-tax Act. In all such cases it may, however, have to be proved by the Assessing Officer that the benefit has in fact gone to any of the persons mentioned under Section 2(24) of the Income-tax Act.

2. CHIT FUNDS

2.1 Introduction: A chit fund is a kind of savings scheme practiced in India. A chit fund company is a company that manages, conducts,

or supervises a chit scheme. It is regulated by the provisions of Chit Fund Act, 1982, which is a central Act. A few states have also passed laws to regulate the business of chit funds. Chit means a transaction in which a person enters into an agreement with a specified number of persons that every one of them shall subscribe a certain sum of money by way of periodical installments over a definite period and that each such subscriber shall, in his turn, as determined by lot or by auction or by tender as may be specified in the chit agreement, be entitled to the prize amount (amount after discount and foreman commission).

2.2 Definition of Terms as in Chit Fund Act: As mentioned earlier, many states have passed their own laws to regulate chit funds in their states. They are Kerala Chit Fund Rules 2012 & Amendment 2016, Tamil Nadu Chit Funds Act, 1961, The Chit Funds (Karnataka) Rules, 1983, The Andhra Pradesh Chit Funds Act, 1971, Delhi Chit Funds Rules, 2007, and Maharashtra Chit Fund Act 1975. Chit Fund Act, 1982 can be referred to for some of the important definitions such as chit, chit agreement, chit amount, defaulting subscriber, discount, dividend, draw, foreman, prize amount, subscriber, prized subscriber and ticket.

2.3 Illustration and Terms Used in Chit Business: In a new chit group that is being commenced, the value of the chit is to be decided. For example, if the value of the chit is taken as 500,000, then this amount is known as the *Chit Value or 'Sala'*. Duration of the chit, if taken as 50 months, then 50 months is the *'Term Period for the Chit Group'.* Chit Fund Company has to gather 50 people who are interested in investing in this chit group. These 50 persons are called *Subscribers.*

Once the chit group commences, the foreman has to register the chit with the registrar of chits. The foreman is the chit fund company. He has to pay 100% of the chit value as security. This amount can be withdrawn only after the said chit group closes and every subscriber is paid what is due to him or her. This regulation protects the interests of the subscriber to a certain extent. The amount to be saved every month by the Subscriber is Chit value/ No of persons i.e. 500,000/ 50 = 10,000. This is also known as *Monthly Subscription.* It may be noted here that the number of persons investing in a chit and the duration of the chit is always the same. The maximum monthly contribution or subscription amount that a subscriber will pay is 10,000. The subscriber does not always pay the entire subscription amount every month. He gets a discount based on the auction bid. The maximum discount or maximum bid permitted ranges from 30–40%. For the purpose of this illustration, let us assume that a subscriber has made bid of 35% of the chit value. 35% of 500,000 is 1,75,000. This amount is known as *Chit Discount.* The foreman charges 5% of chit value as foreman commission. In this illustration, that would amount to 25,000. This is deducted from Chit Discount i.e. 175,000-25000=150,000. This amount is available for equal distribution among the subscribers. In our example, 150,000 would be divided equally among 50 subscribers. Each subscriber would get a discount of 150,000/ 50 = 3000. This amount is known as *Dividend.* In the following month, all subscribers would have to only pay 7,000 instead of 10,000. This is because they have earned a chit discount of 3000.

Depending upon the competition within the chit group, the discount Per cent would vary. The least discount would be 5%, which is the *Foreman's Commission.* The bidding process will continue until the end of the chit period. In this manner, the subscribers can borrow more than what they paid in the first half period of the chit term and save their money if they decide wait further into the chit period. In simple terms, a chit fund is a *Savings Cum Borrowings Scheme,* wherein a few people (known as members or subscribers) come together and invest a fixed amount every month for a fixed period.

The 50 subscribers constitute a 'Chit Group' and the Chit fund company can run many such groups. Approval of bye-laws and commencement certificate for each group from the office of the Registrar, Chit Funds, is must.

2.4 Accounts and Analysis of Accounts: Before going to the accounts, one needs to be clear about terms 'arrears' and 'dues' that are used in chit fund business. The term 'dues' is used only with respect to prized members. The installments receivable not now but at a future date are called 'dues'. When a subscriber, whether prized or non-prized, fails to make payment on the due date it is said to be in 'arrears'. The term 'arrears' refer to the past transactions and the term 'dues' to the future transactions. Chit Subscription Account reveals the amount received from the non-prized subscribers only. Chit Prize Account reveals the subscription due from the prized subscribers only. Auction Dividend Account reveals the amounts, which have to be distributed to the subscribers.

It is better to investigate the chit business by taking any one chit and understand as to how various accounting entries that have been made from the beginning of the chit to its termination. This way, it is easy to find out as to whether income receipts have all been properly taken to the profit and loss account and not to the balance sheet as liabilities. In order for a chit to run, it must be subscribed fully. Sometimes fictitious subscribers are introduced, with a view to making up the numbers. A look into the subscriber's register, with a particular eye for tell-tale markings, may provide useful clues in this regard. If in the case of a subscriber, the subscriptions paid are entered in one lump just before the subscriber gets the prize, it can be reasonably deduced that he is a fictitious subscriber. Hence, a scrutiny of the subscriber's register is essential.

In chit fund business as in any otherbusiness, items of expenditure such as salary paid, commission paid for canvassing subscribers and gifts given to subscribers or agents are particularly vulnerable to inflation etc., might have been inflated. For enrolling chit subscribers, canvassing agents are usually paid 1 per cent of the chit value as commission. Anything more than this can be considered as not normal and enquiries need to be carried out.

2.5 Registers and Other Documents to be Maintained: The Chit Funds Act, 1982 of the Central Government and the laws of the State Government on chits govern the operation of chit companies. Many chit companies have registered and unregistered chits. Unregistered chits are illegal as per law. A chit group registered with the Sub-Registrar Office is a registered chit and one which is not is an unregistered chit. While registering a chit group, the chit company has to deposit an amount equal to the 'sala' value with sub-registrar for the term period. The reason why a chit company would not register a chit is that it loses its working capital during the term period. When a company chooses not to register a chit group, it has the tendency to manipulate its financials accordingly, as there is legal obligation for all chit companies to file the financials in the Sub-Registrar Office.

The following registers and documents that are required to be maintained by a chit company will be useful in Income-tax investigation:

i. Application form used by a foreman for obtaining prior sanction to conduct a chit i.e., forming a chit group. This is useful to decipher the registered and unregistered chits.

ii. Application by foreman to furnish security for conducting the chit. The chit companies are required to furnish security of the 'sala'/ chit amount/ chit value for each chit group to the Sub-Registrar offices. This document is useful to decipher the registered and unregistered chits.

iii. Chit agreement between foreman and subscribers and application for registration of chit agreement. This agreement is useful to decipher the registered and unregistered chits.

iv. **Subscriber Register:** The names and full particulars of the subscribers in each chit together with the number of tickets held by each subscriber and the dates on which the subscribers signed the chit agreement. This register is useful to decipher the registered and unregistered chits.

v. **Auction Register:** This will contain amongst others entries of all the auctioned chit groups, subscribers who attended the auction and prized subscribers. It also contains the minutes of the proceedings of each draw. It is a proof of conducting auctions regularly. This will contain entries of all groups. Hence, the list of registered chit groups can be deciphered from this. It is also useful to verify as to whether one subscriber is a member of more than two chit groups which is a violation of the chit laws.

vi. A ledgeris normally maintained containing, (a) the amounts paid by the subscribers in each chit and the dates of such payments (b) the amounts paid to the prized subscribers and the dates of such payments; and(c) in the case of any deposit in an approved bank mentioned in the chit agreement the date and the amount of such deposit. It will be useful in reconciliation of actual collections from chits and stated collections as per the books of account.

2.6 Concept of Income Recognition: Foreman Commission denotes the commission earned by the chit fund company for conducting various chits. This commission is part of the subscription or contribution money collected from the customer. As per the Central and State Chit Fund laws, the foreman is allowed a fixed percentage as foreman commission at the time of each monthly draw or auction, and is permitted to pay himself from the subscription amount, his commission that becomes due to him at that draw. As per Section 21 of the Chit Funds Act, 1982, the foreman is entitled to commission for running the chit. The relevant extract is reproduced as under:

'Rights of foreman-(1) The foreman shall be entitled,-

a. .....

b. to such amount not exceeding five per cent of the chit amount as may be fixed in the chit agreement, by way of commission, remuneration or for meeting the expenses of running the chit;'

Hence, the commission is earned for running the chit which is the auctioning process. Thus, commission of the foreman accrues at the end of chit auction and it becomes due to him and is payable to him out of the monthly subscriptions. The accrual of income as commission together with the right to receive it, is related to each auction and gets completed on that basis. An auction event can be distinguished from a mere collection event by the payment of auction or prize amount to the prized subscriber. Hence, payment of prize amount can be taken as the point of time when the foreman commission should be recognized.

It is necessary to observe that a foreman does not earn any income by way of foreman commission during the collection of subscription. He earns foreman commission only when he conducts an auction. For example, if a chit company commences forms a chit group in February, 2018 and merely collects subscription for the first two months without conducting an auction, the income of the chit company by way of foreman commission for the financial year 2017–18 with respect to the said chit group is nil.

2.7 Understanding the Financials of Chit Companies

The main items in the financials of a chit company are foreman commission, liabilities to non-prized chit subscribers, bank, cash in hand and receivable from prized and non-prized chit subscribers.

For understanding the accounting entries, consider an example of a Rs. 1,00,000/- chit group with 20 members (foreman being the 20th member). For convenience, let us assume that the auction is conducted in the second month.

Accounting Entries for first month

Cr	Liabilities Chit Subscribers	95000
Dr	Bank	95000

The above mentioned amount is only Rs. 95,000/- as the foreman is the 20th member of the chit group. As there is no revenue element for the foreman in this transaction, the profit and loss account is not affected and it is only the balance sheet where these entries will be reflected as shown below:

Table 1: Balance Sheet

Liabilities to Chit Subscribers	Cr	95000	Bank	Dr	95000
		95000			95000

Accounting Entries for Second Month

Let us assume that, auction is conducted during the second month and the prized subscribers who wins the auction gets a discount of Rs. 20,000/- During the bidding process. In this case, the prized subscriber gets the auction money of Rs. 80000/- After deducting discount of Rs. 20,000/-. The entries can be arranged in 3 parts as shown below:

I. Collection of Money from all the subscribers

Cr	Liabilities to Chit Subscribers	80000
Dr	Bank	80000

II. Auction and disbursement of auction amount to prized subscriber

Cr	Bank	80000
Dr	Receivable from Prized Chit Subscribers	80000

III. Recognition of Foreman Commission as Income

The foreman commission of Rs. 5000/- is realised on auction and it is out of the total of amount collected from the chit subscribers. Hence, realisation or recognition of foreman commission as income leads to reduction in the liabilities to the chit subscribers.

Cr	Foreman Commission	5000
Dr	Liabilities from Chit Subscribers	5000

The net effect of the above transactions will be as under:

i.	Liabilities to Chit Subscribers	–Cr 75000
ii.	Receivable from Chit Subscribers	–Dr 80000
iii.	Foreman Commission	-Cr 5000

The profit and loss account after this transaction will appear as under.

Table 2: Profit and Loss Account—Realising Foreman Commission

Net Profit	Dr.	5000	Foreman Commission	Cr	5000
		5000			5000

The balance sheet will be appearing as shown below.

Table 3: Balance Sheet—Realising Foreman Commission

Reserve and Surplus	Cr	5000	Receivable from Chit Subscribers	Dr	80000
Liabilities to Chit Subscribers	Cr	170000	Bank	Dr	95000
		175000			175000

2.8 Common Modus Operandi of Tax Evasion Found in Chit Companies and a Case Study

2.8.1 Suppression of Foreman Commission: This is the most common method of tax evasion. In most cases, the foreman commission earned out of unregistered chits is not accounted for in the books of account. To work out the actual foreman commission as per the income recognition concept explained earlier, the percentage of foreman commission on the total 'sala' values of all payments made during the financial year will give the actual foreman commission earned. The difference between this actual foreman commission and the one reported in the books of account will reveal the suppressed income from foreman commission. The registers mentioned earlier in para 2.6 supra, will be useful in working out the foreman commission.

2.8.2 Wrong Claims in Bad Debts Written Off: Although the chit companies are allowed to write-off any amount as bad debt, the accounting criteria followed has to be uniform across the years. Further, collections which are not accounted in the regular books of account are written off. To verify such bogus claims, each debt written off requires to be verified.

2.8.3 Suppression of Bad Debts Recovered: The chit company may camouflage recovery of bad debts which were earlier written-off as collections against fictitious subscribers. As collection of subscription does not automatically lead to an increase in income, the same would feature in balance sheet as 'liabilities to non-prized chit subscribers'.

2.8.4 Bogus Agent Commissions: Agent commission is paid to a person who brings in customers to join chit groups. Many chit companies use this as a method to make bogus expense claims and also for money laundering purpose.

2.8.5 Case Study: ABC Chits Private Limited

ABC is into the business of running chits. A search was conducted in this case on 19/04/2017 during which the following *modus operandi* of tax evasion was detected.

i. **Suppression of Foreman Commission:** Although ABC had registered all the chit groups, it was unearthed on examination of the SQL database that a portion of the foreman commission was suppressed every year. The SQL database was queried to extract data of foreman commission and this revealed that the foreman commission reported in the return of income was suppressed. The method followed is similar to the one mentioned earlier elsewhere in this Chapter.

ii. **Suppression of Bad Debts Recovered:** ABC had periodically written off dues more than 6 months old as bad debts written off. However, the corresponding collections made in subsequent years were suppressed by recording the same as subscriptions received in the balance sheet. Examination of collections pertaining to bad debt customers in the SQL database led to the detection of this modus.

iii. **Undisclosed Bank Accounts:** ABC collected interest on default payments. Default payments are delayed payments made by the subscribers after the completion of the term period of a chit group. Interest was collected at 18% on the default amount. These interest amounts were collected by ABC only in cash and deposited into bank accounts which did not form part of ABC's regular books of account. During the course of search proceedings, 102 such undisclosed bank accounts were unearthed.

3. KURI COMPANIES OF KERALA

3.1 Introduction

The chit fund companies of Kerala operate differently from the chit fund companies operating in other parts of the country. The Government of Kerala has passed the Kerala Chitty Act, according to which the auction amount is restricted to 30 per cent of the total prize amount. When there are more than one contender for the auction, the winner is decided by a lot. Thus, effectively the auction also turns out to be based on taking the lot. Majority of the chit fund companies in Kerala conduct kuri business by starting a branch in either Jammu or Faridabad thereby extricating themselves from the regulations of the Chitty Act. There are no restrictions on auctioning in respect of kuris started from branches in Jammu and Kashmir and Haryana. Hence, most of the kuri companies functioning in Kerala have a namesake branch in these places. The entire business activities are carried out in Kerala and there is only a name board in Faridabad or Jammu.

3.2 The Incomes Derived by the Kuri Companies

The usual incomes are foreman Commission, interest on delayed payment of monthly/ quarterly subscription and premium on forfeited kuris.These incomes are to be recorded in the books and reported for tax purposes, may go unreported. Expenses are sometimes inflated and a part of the income taken away from taxation.

3.3 Modus Operandi of Tax Evasion

i. **Profit on Transfer of Prized/ Auctioned Kuris**: Most kuris started from Faridabad/ Jammu branches have got the system of prizing and auctioning simultaneously. In the case of prized subscribers the company offers premium for transfer of the prize amount to needy customers. This premium is shared between the company and the prized customer totally outside the books. If a kuri of prize amount of Rs. 1 lakh is prized by a subscriber during the early stages of the kuri, premium of upto Rs. 50,000/- is available. Even for auctioned kuris some kuri companies give premium and transfer the prize amounts to needy customers.

ii. **Subscription in Company's Own Name**: Usually, kuri companies subscribe to a large number of tickets in their own names. Some of the companies resort to unfair means in taking lots with the result that the winners of the lots are the company tickets. These are then transferred to needy customers on their paying hefty premiums.

iii. **Bogus Liability Claim:** In almost every kuri there are a number of defaulters. As per the rules of the company, if there is continuous default for more than 3 months, the subscribers forfeit their subscription. At the closure of the kuri these amounts are supposed to be returned to the subscribers. In actual practice, the company claims the amount as liability but never returns it. After some time, it may show the amount as paid without making any payment at all.

iv. **Interest on Passbook Loans:** Generally kuri companies grant loans on the security of non-bid/ non-prized passbooks. The loan amount may be as much as 60 per cent of the actual amount remitted by the subscriber. The company charges interest on such loans at high rates. The books reveal only a nominal interest. Through enquiries the truth can be culled out.

v. **Interest on Advance Payment of Kuri Prize/ Bid Amount:** As per the kuri rules, the prized/ bid subscribers are entitled to bid/ prize money after ten days of the next instalment, i.e. after 40 days in the case of the monthly kuri, 100 days

in the case of the tri-monthly kuri and 130 days in the case of pooval kuri (kuri conducted once in four months). This period is provided for in the kuri rules in order to give time to the subscriber to submit adequate security, verification and acceptance of the same by the foremen and for executing necessary bonds. The traders who join the high denomination kuris are often in need of funds for their business purposes. Waiting for such long periods may not suit their business needs. They approach the foreman to realise the bid/ prize money ahead of the due dates. Usually, the foreman allows the subscriber to draw the prize/ bid amounts but charges interest @ 18 to 30 % per annum for the period from the date of payment to the due date. Such interest is rarely offered for assessment. Hence, all cases of advance payments should be checked for the interest collection.

vi. **Profit on Terminated Kuri:** The prized/ bid subscriber loses the benefit of auction, discount, fixed discount and bonus when he fails to remit the subscription on due dates. In a case of three consecutive defaults, the ticket is treated as forfeited and such subscriber is entitled to get only the amount paid by him as reduced by the foreman's commission. All benefits accruing to his ticket are denied. All these discounts/ bonus forfeited are the income of the foreman. However, in most cases no such income is disclosed. This is on the plea that under the scheme of the kuri, profit or loss can be ascertained only at the time of its termination. Even after the termination, the profit is not offered for assessment on the plea that large amounts are due from the subscribers and the profit can be brought to tax only after all the dues are collected.

vii. The final accounts filed along with the returns of income seldom disclose the fact of termination during the relevant year. The financial accounts are made by the companies usually in three parts. They are (i) Profit and loss account (ii) Kuri statement and (iii) Balance Sheet. The kuri statement depicts the assets and liabilities of all chitties conducted. The statement is tallied with an item called 'company account'. This item is brought to the balance sheet. On a perusal of the kuri statement one can see liabilities of crores of rupees under auction discount payable account, fixed discount payable account and bonus payable account. The statement never gives an item wise tally as to which kuris the payable account relates. If these payable accounts are analysed, one can see that a good portion of the credit balances of these accounts pertain to terminated kuris and are non-existent liabilities which should have been offered for taxation much earlier. After the termination of the kuris the foreman is not legally bound to give any discount or bonus and such liabilities cease to exist. They are his income.

viii. In kuri business inflation of expenses takes place under the head such as, inflation of travelling expenses, Kuri canvassing commission, Daily collection commission, Business promotion expenses, Incentives, Sitting fees/ conveyance allowance to directors, Inflation of other expenses like office expenses, kuri preliminary expenses and commission, etc. Most of the companies inflate expenses under these heads with a view to reduce the profit. Proper vouchers are not kept in support of the expenditure claimed under the above heads. Due alertness on the part of the AOs will help greatly in checking and finding out the inflation in expenditure.

4. NBFC: GOLD 'LOAN COMPANIES'

4.1 Introduction

The business of gold loan in the NBFC,as one of the oldest forms of secured lending has grown manifold over the last decade. Share of lending on gold outside bank and NBFCs is more than 50% and they are in informal lending sector such as local pawn brokers and money lenders. The gold loan lending by NBFC has grown manifold due to the untapped informal nature of the sector.

A Non-Banking Financial Company that is lending loan based on the security of gold ornaments, is a company registered under the Companies Act, 1956 engaged in the business of lending loans.The lending interest rate is not controlled by the RBI since it has deregulated interest rates to be charged from borrowers by financial institutions (other than NBFC-Micro Finance Institution). The rate of interest to be charged by the company is governed by the terms and conditions of the loan agreement entered into between the borrower and the NBFCs. However, as per circular of the RBI, NBFCs have to be transparent and the rate of interest and manner of arriving at the rate of interest communicated explicitly in the sanction letter.

4.2 Relevant Acts/ Regulations

These NBFCs are basically incorporated under Company Act and are defined in Section 45 I(f) of RBI Act 1934. The NBFCs which are into the business of gold loan, are monitored and controlled vide Master Direction in DNBR.PD.008/ 03/10/119/ 2016–17 Dated 01/09/2016. (Refer RBI's site www.rbi.org.in) of RBI.

4.3 Relevant Accounting Standard

As per the notification of the Companies (Indian Accounting Standards) Rules, 2015 on February 16, 2015 and subsequent press releases by the MCA, the roadmap for implementation of International Financial Reporting Standards (IFRS) converged Indian Accounting Standards for banks, non-banking financial companies, select All India Term Lending and Refinancing Institutions and insurance entities. In this connection, it is advised by RBI that select All-India Term Lending and Refinancing Institutions (AIFIs) (Exim Bank, NABARD, NHB and SIDBI), shall follow the Indian Accounting Standards as notified under the Companies (Indian Accounting Standards) Rules, 2015, subject to any guideline or direction issued by the Reserve Bank in this regard, in the following manner:

i. AIFIs shall comply with the Indian Accounting Standards (Ind AS) for financial statements for accounting periods beginning from April 1, 2018 onwards, with comparatives for the periods ending March 31, 2018 or thereafter. Ind AS shall be applicable to both standalone financial statements and consolidated financial statements. "Comparatives" shall mean comparative figures for the preceding accounting period.

ii. AIFIs shall apply Ind AS only as per the above timelines and shall not be permitted to adopt Ind AS earlier.

4.4 Modus Operandi of Tax Evasion and a Case Study

4.4.1 Short-Accounting of Interest Receivable

In any gold loan company, wherever the income accruing to them will be worked out on the basis of mercantile system, the income arising to the company on account of interest will comprise of twocomponents, namely interest received and interest receivable. In both the cases, as per the Income-tax Act, 1961 working needs to be on the basis of the percentage of interest charged as per loan agreement in the case of loans where repayment is being regularly made; and interest

chargeable as per the loan agreement in the case of loan where defaults in payments are there. However, the gold loan companies may resort to certain manipulations as detailed below:

Scenario 1

Gold Loan Company receives interest from its customer(s) on the loans advanced by it. Out of such interest receipts, the gold company resorts to suppress actual receipts by not accounting it in the books of account. Investigator may have to ascertain the system deployed by the asseesee to account for the interest; and then find out as to whether any interest receipt is suppressed. In a multi branch gold loan company, the interest receipts will be accounted in the branches and the get communicated to the head office using softwareeither in a real time core banking system or through email. The data received in mail are later consolidated at different time intervals. The investigator must understand the flow of communication to ascertain the points to which such communication gets disseminated, for consolidation and for consumption of the top management.

Scenario 2

Gold Loan Company may resort to methods to restrict the interest receivable to certain artificially created benchmarks. A method, usually followed is restricting the interest receivable is on the basis of 'realisable market value' of the gold ornaments pledged. The modus operandi may be explained as follows: A company may have a loan portfolio of Rs. 75 crores which is lent at 18% interest and the replacement of which is in default. The gold ornaments pledged with the company corresponding to the loan amount of Rs. 75 crores are 400 KG of Gold (if 75% is the loan granted of the market value at Rs. 2500 per gram). In such a case, the company will artificially restrict its interest receivable based on a value, which it considers as the realisable market value of gold ornaments lying with it. In the present case, say, the gold loan company will restrict the value of gold to Rs. 2000/- per gram and then work out the interest receivable on the basis of such working.

To Illustrate:

Table 4

Loan Advanced	Rs. 75,00,00,000/- Being 75% of market value of gold ornaments of 400 KG pledged with gold loan company
Gold Ornaments pledged	4,00,000 grams
Interest receivable @ 18%	Rs. 13,50,00,000/-
Market realisable value as per the gold loan company	Rs. 2000 per gram
Interest receivable as per the above market realisable value	4,00,000 gms * Rs. 2000/- per gram = Rs. 80,00,00,000/- minus Rs. 75,00,00,000/- = Rs. 5,00,00,000/-
Interest receivable short accounted	Rs. 13,50,00,000/- minus Rs. 5,00,00,000/- = Rs. 8,50,00,000/-

In this illustration, the interest worked out based on realizable value of the gold is Rs. 5 Crore, whereas the interest if worked out in normal method say at 18% is Rs. 13.50 crores. By adopting the method of market realizable value, the interest receivable is brought down by Rs. 8.50 crores. The market realizable value is appropriate where the loan advanced becomes bad and principal and interest is recovered through auction of pledged gold jewellery. But, the percentage of loans which is bad or prone to become bad is only a small portion of the loans advanced and outstanding at the end of the year.

Further, while issuing loans under various schemes of gold loans, a portion of the interest rate charged as an additional interest in the name of 'risk interest' is collected. While compiling the final accounts, this 'risk interest' is usually omitted to be shown as interest in the *P&L* Account.

4.4.2 Undisclosed Profit on Sale of Gold Jewellery

The most important source of suppression of income is from sale of gold jewellery of the customers who fail to turn up to redeem the pledged jewellery. The *sale proceeds through auction of the gold jewellery is always higher* than the principal loan lent and interest receivable. This is due to the fact that the principal lent is usually less than the actual value of the gold jewellery pledged. This is due to the regulation of the RBI to the effect that loan to value of the gold should be (LTV ratio)75%. Another important market related reason is that there is always growth in the price of gold with an exception in a few years (there was a decline in the annual average growth rate only in 4 years in the past 4 decades). The sale proceeds of pledged gold jewellery is always higher than the amount that the customer owes to the company i.e., principal and interest. The surplus arising out of auction of pledged gold jewellery should be returned to the customer. Most of the companies never pay the surplus to the customer whose pledged items were sold as has been noticed in a recent search case in Kerala. Further, NBFCs were found violating the RBI's norms, wherein it was mandatory on the part of the NBFCs to provide full details of the value fetched in the auction, the outstanding dues adjusted and any amount over and above the loan outstanding should be payable to the borrower.

The surplus receipt arising from sale of gold is not recorded in the books of account and cash receipt generated, thus, is undisclosed income. The companies flout the RBI circular and norms with reference to how the gold jewellery pledged need to be weighed and how receipts are with a view to suppressing the gold weight pledged.

At the counters of the branches, receipt is issued for the pledged gold jewellery mentioning the weight. The receipt contains gross weight and net weight. The net weight is arrived at by reducing random grams towards lack of purity of the gold jewellery. The checking of the purity of the gold is not undertaken and actual purity of each and every piece of jewellery brought by the customer is not appraised to arrive at the net weight which is mentioned in the receipt. Hence, the net weight mentioned in the receipt issued to the customer is not the actual net weight of the jewellery. The net weight in the receipt issued to the customers is always lower than the actual net weight.

In the auction, the sale proceeds of gold disclosed in the accounts is equivalent to the total of net weight as shown in the receipt issued to the customer, whereas the weight of the actual gold auctioned is much higher than the total of the net weight. The sale proceeds, proportionate to the quantity of gold which is not accounted in the pledged gold jewellery is undisclosed gains to the NBFCs.

4.4.3 CASE STUDY: Gold Loan Companies and Unaccounted Income Generation

In order to understand the generation of unaccounted income from auction proceeds, it is essential to keep in perspective the whole process of gold loan disbursal and the auction procedures.

The Process of Gold Loan Disbursal: Whenever a prospective customer approaches a gold loan company for loan, the loan is disbursed on the basis of a loan sanction letter signed by the customer and branch manager. The loan sanction letter generally contains the address of the branch, name and address of the customer and customer id, loan amount, loan type, date of advancing the loan and interest rates. The weight of the gold ornament is weighed in the presence of the customer and the gross weight of jewellery pledged, deduction on account of stone & impurities, net weight etc. are entered therein. For instance, if a customer approaches a gold loan company with a gold ornament that does not contain any stone and is a fresh piece

of gold ornament purchased from a branded jewellery shop that weighs 4.8 grams, the gross weight of the jewellery is recorded as 4.8 gram. Deduction of 0.2 gram is seen as attributed to a presence of stone and impurities. Thus the net weight is recorded as 4.6 gram. However, the jewellery pledged by the customer may be a BIS 916 hallmarked gold ornament weighing 4.8 grams. The point is, the deduction of 0.2 grams, in the instant case, was purely arbitrary and without any rationale. Yet, it is a fact that, in several cases the ornament pledged would have stone or some impurities.

In any case, the loan amount sanctioned is a predetermined percentage (generally varying from 70% to 80%) of the market value of the gold on that particular day. Therefore, the Company needs to know the net weight of the ornament being pledged. Therefore, a deduction on account of weight of stone and impurities (in case, the jewellery in question does have stone and impurities) is justifiable to an extent.

'Actual Net Weight' and 'Accounted Net Weight': The issue that is germane from an investigation point of view is not that a 'deduction' as mentioned above is being made. Rather, the issue pertains to the manner in which the deduction is worked out. For a gold loan company with multiple branches and even for a single branch gold loan company, there will be no scientific mechanism to determine the weight of stone or impurity. The gold loan companies generally don't possess any technical expertise in this regard. Therefore, in reality, only the gross weight is known with certainty and the deduction on account of stone or impurities is merely a matter of estimation. The gold loan company will estimate the net weight preferring to be on a safer side, as a result of which the "*Net Weight*" entered in the loan sanction form and thereafter in the records of the Company, is invariably lesser than the "*Actual Net Weight*". Moreover, even in cases where the jewellery pledged is a 916 BIS hallmarked one without any stone (and hence with no justification for a deduction), a deduction is invariably made from the gross weight in an arbitrary manner. Thus, the fact is, the net weight of the pawned jewellery as per gold loan company's records, is always lesser than its actual net weight. In the ordinary course of business, when the customer repays the loan (and takes back the jewellery), the difference between the "documented net weight" and the "actual net weight" hardly matters. However, in a scenario where the borrower defaults and the company ends up auctioning the jewellery, this difference in weight assumes importance.

The Small, Yet Big Difference: In almost all cases, customers at the time of pawning the gold, intend to take it back. Moreover, the difference (between actual net weight and accounted net weight) in individual cases may not be large enough to affect the loan eligibility to any significant extent. Therefore, the customers at the time of pawning the gold, may not make an issue out of this difference. In some cases, there may not be even aware of the same.

However, as stated already, wherever customer would find it impossible to repay the loan and therefore his/ her jewellery is sold in auction, the gold loan company generates unaccounted income. Let us suppose that, the 916 BIS hallmarked ornament as stated above (weighing 4.8 grams, without any stone) in the above illustration ends up being auctioned. If the gold rate on the day of auction is Rs. 2,500/- per gram and 90% of the market rate is received in auction, the Company would receive an amount of Rs. 10,800/- from the sale (4.8 x 2,500 x 90% = Rs. 10,800/-). However, the quantity available as per Company's records is only 4.6 grams and therefore, the Company is not in a position to show that the quantity (that is, net weight) actually sold was 4.8 grams. Therefore, the Company would account a receipt of Rs. 10,350/- (that is, 4.6 x 2,500 x 90% = Rs. 10,350/-) and the balance amount of Rs. 450 goes unaccounted. The accounted receipt of Rs. 10,350/- would be received as RTGS and the unaccounted portion of Rs. 450 would be received as cash in the branches.

If we consider individual cases, the difference in weight may be a few grams and corresponding difference in receipts may be a few thousands. However, from an investigation point of view, such unaccounted receipts assume huge proportions when all such defaulted customers' gold ornaments are auctioned. The entire sale proceeds of gold ornament is not accounted. Instead, a portion of the sale proceeds of gold ornament that is claimed as deduction from the gross weight to arrive at net weight, is not accounted in the books of account of the assessee.

4.5 Check List/ Suggested Lines of Enquiry

a. NBFCs indulge in entry entry operator rackets. Their bank account analysis gives the entire chain of bank accounts used for circular transaction.

b. Investigation of KYC document of NBFC may reveal undisclosed accounts.

c. After demonetization there is a trend to withdraw cash for unaccounted expenses. Details may be sought in respect of the accounts, wherefrom substantive cash withdrawals were made.

d. TDS violations may also be probed

4.5.1 Further the Following Points are also Required to be Kept in View

The task of the investigator is to identify the various ways in which data relating to such unaccounted sale receipts are maintained. In large gold loan companies, there will be a centralised system, where the details of unaccounted receipts from such auctions are maintained systematically for the consumption of the top management since the system is generally employee managed. Also, as per the guidelines issued by RBI, the gold ornaments are to be auctioned only at the state or district in which the gold ornaments are pledged by the customers. Hence, the entire auction proceedings will be conducted in a decentralised manner requiring the involvement of multiple persons. However, in practice the bidders for auctioned gold of a gold loan company, even at multiple locations, will generally be the same irrespective of the auction location. This is to facilitate easier control of the unaccounted cash generated.

The investigator should invariably look for details of actual weight auctioned and the handling of the unaccounted cash generated. The former will be generally available with the persons handling the auction at respective places and the person who will be overall in charge at the head office, if any. As regards the latter, i.e., the unaccounted cash generated, the details are bound to be available with the successful bidders at the auction and also with the employees, who handle auction portfolio of the gold loan company. There could be scenarios in the case of large gold loan companies, wherein the entire unaccounted income generated through auction is centrally managed and accounts relating therein is maintained using a core banking solution. In such cases, the access to such modules of the core banking solution will be available only to key employees who will be managing the unaccounted transactions. In the case of small gold loan companies, the details may be maintained in excel sheets or even manually depending on the sophistication of employees who handle as per the preference of the owner.

5. LEASING COMPANIES

5.1 Introduction

Lease is a contract between the owner of a property (the landlord or lessor) and another person (the tenant or lessee) that grants exclusive possession of the property to the tenant for an agreed period on mutually agreed terms. Lease is a kind of contract for (i) the exclusive possession of property for a determinate period of time or at will and (ii) rent. The person making the grant

is called the lessor, and the person receiving the grant is called the lessee. Two important requirements for a lease are that the lessee has exclusive possession (non-exclusive possession would call for a license) and that the lessor's term of interest in the property be longer than the term of the lease (a grant involving an equal term or period would comprise a conveyance or assignment is not a lease)

5.2 Types of Lease Transactions

There are following three types of leases.

5.2.1 Finance Lease

It denotes a lease of fixed assets for a certain term where the lessor finances the cost of the asset and transfers the right to use the property along with the risk and the rewards that are incidental to the holding of such asset whether or not the title is eventually transferred to the lessee. Most of the prevailing financing deals come under this category. The scheme envisages payment of rentals to the lessor for a certain term including the non-cancelable lease period which is sufficient to recover the investment made by the lessor along with a reasonable profit thereon. The Finance lease is basically a loan in disguise.

5.2.1.1 Types of Finance Lease: There has been a proliferation in the number of companies which are basically providing funds for fixed assets in the form of leasing. Depending upon the situation and needs of one User Company to another, schemes can also undergo change to accommodate the requirements of user companies. This has resulted in the evolving of several categories of finance leases.

Lease by Manufacturer: The lessor is the manufacturer of the leased asset. The asset is leased either directly to the lessee or through an in-house financial company, which may purchase the asset and then lease the same to the lessee. Normally, in such cases, the services are provided by the manufacturer company which may have such kind of arrangement. In this type of cases the lease agreement may either include the service contract covering all the players in the transaction or the agreement relating to provision of services which may have to be made separately.

Lease by Supplier or Vendor: Sometimes, the suppliers of equipment (who are not manufacturers themselves) try to boost the sale by having a financial intermediary. This form of leasing is known as Vendor leasing.

Leveraged Lease: When the lessor is not able to finance the purchase of the asset fully because of the price of the asset, heropes in a lender who provides finance towards a larger part of the cost. The three parties i.e. the lessor, the lessee and the lender become part of the lease agreement. The lender is a major financier and is assured of a certain return on the fund provided by him to the lessor either in the form of interest or a part of the lease rental. The asset is however mortgaged to the lender.

Big Ticket or Syndicated Lease: In many cases, the assets involved in leasing require a large amount of investment like purchase of aircraft, ship etc. As it becomes nearly impossible for one lessor to prove the entire amount for the purchase of such assets, many financiers come together and act as Co-lessors sharing the lease rental in proportion to their investments. The lease agreement remains one and the Co-lessors and lessee are parties to the agreement.

International or Cross Border Leasing: As opposed to domestic leasing where all the parties to a leasing arrangement belong to the same country. International or Cross border leasing involves parties from different countries who join their hands together in a leasing transaction. As the lessor, lessee and financier belong to different countries, the process of International Leasing is difficult and complex, and has to consider several other aspects which are not common to domestic leasing.

Sale and Lease Back: This is a popular device of raising funds by business people in India. Under this scheme, lessee who is the

original owner of the asset sells the asset to the lessor who in turn leases back the asset to the lessee. The asset remains with the lessee who enjoys the ownership of the same. However, an agreement is executed after negotiation when the lessee gets certain money in consideration for sale of the asset and lessor become entitled to enjoy depreciation and lease rental. This is often resorted to by both the lessee and the lessor primarily as a tax avoidance device.

5.2.1.2 Features of Finance Leases

The basic advantage may be tax relief that a lessor enjoys in the form of depreciation. Very often, assessees in the higher tax liability group resort to lease financing for minimising the tax burden.

5.2.1.3 Certain Main Features

Lease financing companies provide complete funding for the purchase of the capital asset. Unlike other loans, there is no requirement of an immediate down payment of a large amount. This enables the lessee to start the business with the amount of working capital only. Since almost the entire fund is available for meeting working capital needs, it is likely to bestow on a lessee competitive advantage over other players in the market.

As a method of financing, it is cheaper than the alternative courses of borrowing.

The leased asset is not shown as an asset in the balance sheet. The liability on account of lease financing is also not depicted as a liability in the balance sheet. This transaction is therefore, known as "off Balance Sheet financing". The item is shown in the balance sheet by way of a foot note. As this does not form part of a balance sheet, the lease financing does not affect either the debt equity ratio or the debt raising capacity of the lessee.

Lease financing also does not dilute the ownership or control of the promoters because of the method of financing.

Lease financing agreement is easier to negotiate and is free from complex procedures as compared to institutional finance. It involves much less documentation and does not impose any restrictive conditions;

The lease rentals are normally structured keeping in view the cash flow of the lessee. The lease term is also selected in consideration of the lessee's capacity and the yield of the asset over its economic life or the lease term;

The lease term and rentals are also structured to provide maximum tax benefits to the lessee;

In case of lease financing the risk of obsolescence is shifted to the lessor as he is the owner of the asset and the lessee can always request for replacement of the existing model by the latest one.

5.2.2 Operating Lease

In an operating lease the lessor does not transfer the asset nor recover the full investment along with the profit thereon from a single lease. The lessor provides services attached to the leased asset and recover the cost for the services provided. An operating lease is basically an economic service. The lease under this head includes hiring of Computers—with operators, office equipment, automobile trucks, taxi, Mobile cranes with operators, chartering of aircrafts and ships including provision of crew and fuel.

5.2.3 Long-term Conveyance Lease: These are long tenure leases which spread over a very long period. This happens mostly in the case of lease in immovable property where lease right extends to a period of 99 years or more.

5.3 Accounting of Leasing Transactions

The Institute of Chartered Account of India (ICAI) has prescribed AS 19 as accounting standard and should be applied to accounting of finance leases and operating leases. This accounting standard is not required to be followed in lease agreements such as, (a) to explore for or

use natural resources, such as oil, gas, timber, metals and other mineral rights (b) Licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights and (c) lease agreements to use lands. Accounting for hire purchase transactions is done as per the generally accepted accounting principles which is to record the cash value of the asset in the books of the hirer (Accounting Standard-10).

5.3.1 Accounting in the Books of the Lessor in the Case of Finance Lease

Finance lease has been defined in the AS 19 as one where lease transfers substantially all the risks and rewards incident to ownership of an asset. An operating lease is defined as a lease other than a finance lease. The finance lease secures for the lessor the recovery of the entire capital outlay plus a return on the funds invested. An operating lease, however, does not ensure recovery of the entire investment plus a return on such investment from a single lessee.

The entries to be made in the books of the lessor as per the guidance note of Institute of Chartered Accountants of India can be briefly summarised as under: Asset leased under a finance lease should be disclosed in the balance sheet of the lessor as an 'Asset given on lease' under the head 'Fixed Assets'. Lease rentals (received or receivable i.e. on due basis) under a finance lease should be shown separately under 'Gross Income' in the Profit and Loss account of the relevant period (credit side) on gross basis (i.e. total rental). Gross rental has two components *viz.* (i) Principal and (ii) Interest. A part of the principal amount is returned which is known as annual lease charge. Interest is also charged on the outstanding amount which is known as finance charge the gross rental received towards the principal amount as well as a payment towards the interest. These two amounts are to be ascertained and segregated for accounting purposes.

5.3.2 IRR Calculation

The lease rentals relating to finance lease consists of 2 components i.e. rental receipt and financial charges. Financing charges represent income and are accordingly chargeable to tax. The amount received towards capital recovery constitutes the capital receipt and is adjusted against cost of the asset. In order to segregate the amount of gross rental into two parts, the finance charge or interest element has to be ascertained first. The amount of Finance charge if deducted from the gross rental will represent the annual lease charge i.e. refund of the principal amount. The finance charge can be ascertained by applying the internal rate of return or implicit rate of return (IRR). The accepted target is the sum of digits method for the purpose of calculation of finance charge on the basis of Internal Return Receipt. The Internal Rate of Return is normally calculated on trial and error method by keeping in view the discounted value. The table indicating the personal value of sale, 1 rupee respectively at the end 1, 2, 3, 4, 5 years etc. is normally available in any standard financial management book. The Internal Return Receipt is so calculated to match up the investment. The interest component is calculated applying IRR. The balance amount is the annual lease charge or recovery towards principle amount. The IRR can be worked out by referring to NPV & IRR table in any Standard financial management book.

If an asset is leased for a particular term and if there is no residual value after the expiry of period, then the value of the leased asset should be written off over the period of the lease which means the annual lease charge should be the amount of depreciation in respective years. But in the case of a company, depreciation cannot be equated with the annual lease charge as depreciation in such cases is charged according to rates prescribed in Schedule XIV of the Companies Act. There is, therefore, bound to be a difference between these two figures. The depreciation account and the profit

and loss account are to be debited with the amount as per rates prescribed in the schedule. If the annual lease charge is more than the depreciation debited then the excess amount is debited to lease equalization a/c and credited to lease terminal adjustment account. On the other hand if the annual lease charge is less than the statutory depreciation than the reverse entry is passed. The lease equalization account is closed by transfer to Profit and Loss account. The lease Terminal Adjustment a/c is reflected in the balance sheet. The basic idea of adjustment is to increase or decrease the amount of statutory depreciation so that is comes at part with the Annual Lease charge.

5.3.3 Lease Terminal Adjustment a/c: This account will either show a debit or credit balance at the end of each year. In case of debit balance, the same should be shown under the head "current asset". If there is a credit balance, the Lease Terminal Adjustment should be reflected under the head "current liabilities". Alternatively the amount can either be added to or deducted from the lease value of the asset. At the end of the lease term, the balance standing in the Lease Terminal Adjustment account should be closed by transfer to leased asset account or shown as a deduction from the books value of the leased asset.

5.3.4 Statutory Depreciation

It should be shown as a separate item in the Profit and Loss account and the accumulated depreciation should be deducted from the original cost of the leased asset.

a. **Lease Equalisation Account:** It can either be transferred to Profit and Loss account or can be disclosed as a deduction from/ addition to gross rentals.

b. **Sale by Manufacturer or Dealer**: When a manufacturer or a dealer sells an asset and leases the same to a lessee, he earns two types of income:

   i. Normal trading profit on sale of the asset.

   ii. Finance income or charge from the lessee.

The guidance note provides that the profit on sale of such asset should be taken into account in the year of lease. The asset should be transferred to "Fixed Asset on lease A/c." The finance income should be computed on the same lines as mentioned earlier.

5.3.5 Issues Relating to Sale and Lease Back

If the rentals and sale price are at fair value then it is a normal sale transaction and any profit or loss arising therefrom should be recognised immediately on the occurring of the transaction.

If the sale value is below the fair value and the loss is compensated by low future rentals. The loss is deferred and amortised in proportion to the rental income over the lease period.

If the sale value is above fair value the excess over fair value is deferred and amortised over the useful life of the asset.

5.3.6 Lease Management Fees (LMF): The guidance note suggests that the lease management fees should be reckoned on accrual basis as income. LMF should be considered for IRR calculations, unless LMF is accounted for on receipt basis.

5.3.7 Accounting in the Books of the Lessor in the case of Operating Lease

Operating lease is a lease where the recovery of the capital investment and a return thereon is not ensured during the lease term. The asset is leased to more than one lessees for different periods. The asset is therefore treated as a fixed asset by the lessor and rentals should be included in his income. The initial costs incurred by the lessor in negotiating and arranging the lease should be charged in the year they are incurred. The depreciation in respect of the leased asset should be charged by the lessor in the same way as done in the case of other assets.

5.3.8 Accounting in the Books of the Lessee in the Case of Finance Lease

The asset taken on lease by the lessee should be disclosed by way of a footnote to the Balance Sheet. The obligations on account of lease i.e. the amount still outstanding should be disclosed in the footnote. The lease rental paid should be accounted for on accrual basis over the lease term. The amount should be appropriately apportioned over the period so that the proportionate amount is charged every year to the profit and loss account. For quantifying the proportionate amount to the Profit and Loss a/c the guidance note suggests certain norms for consideration like-terms of the lease agreement, type of asset, proportion of lease period to the life of the asset etc. The excess of lease rental over such amount in any year, if any, should be treated as prepaid lease rental and vice versa.

5.3.9 Accounting in the Books of the Lessee in the Case of Operating Lease

The aggregate amount of lease rentals payable over the lease term should be aggregated and spread over the term of the operating lease on straight line basis, irrespective of the payment schedule as per terms and conditions of the lease deed. In case the lease period is less than a year the same should be charged to profit and Loss a/c in the year itself.

5.3.10 Sale and Lease Back or Leasing Transaction

The leasing transactions can be bifurcated into two categories: Such transactions where the seller and lessee are one and the same person, and the other party involved is the buyer (which invariably is a finance company), who in turn becomes the lessor of the asset when the circle of the transaction is complete and the purchased asset is leased back to the original seller. In such type of transactions, since the party who sells the asset, takes it back on lease from the purchasor/ lessor, these transactions are called "sale and lease back transactions". Invariably in such transactions, the seller never physically parts with the asset.

The other category is that of such transactions where there are three or more parties involved i.e. all leasing transactions, other than the sale and lease back transactions. In such transactions, seller, lessor and lessee are the three distinct entities. In other words, the seller of that asset and the lessee to whom the asset is leased out are not the same party as is the case in the sale and lease back transaction. These transactions are normal leasing transactions, frequently entered into by the finance companies as purchaser/ lessor of the asset. The company which required a particular asset for its use, usually identifies the supplier, carries on the negotiations regarding the price, installation and delivery schedule of the asset and finally approaches the finance companies to purchase the asset and give the same to itself on lease. In the case of such assets the lessor got a deduction in the form of depreciation from its taxable income, equivalent to the money spent on the purchase of the asset. In the subsequent years, the lease rental received from the lessee was offered to tax since the lease period in most of the lease transactions was between 5 to 7 years, the amount of tax saved during the financial year in which the purchase was made, got deferred by 5 to 7 years as a consequence the tax liability postponed.

5.4 Modus-operandi of Tax Avoidance/ Evasion

Misuse of provisions in order to derive the benefits beyond the permissible limits of law by circumventing the requirements and conditions as laid down in the Income-tax Act has been noticed in a number of cases.

5.4.1 Depreciation Claimed on the Transfer of a Bogus or Non-existent Asset

Assets that are sought to be transferred and subsequently leased either to the transferee itself or to any third party were found to be bogus or non-existent in many case. The lessor in collusion with the lessee and the supplier (the last two happen to be same in the case of sale and lease back transactions), have been found

to have raised fake invoices for non-existent assets and claimed depreciation on the same. In many of the cases, it was seen that the asset on which the depreciation was claimed was never manufactured by the supplier in question or in some cases the supplier itself was found to be non-existent or was not engaged in manufacturing of that at all. Field inquiries reveal that either no such supplier was in existence or supplier denied having any transaction. Investigations in such cases have established that the asset in question was never in the possession of the assessee. In cases of non-existent asset, the transaction entered into between the lessor and the lessee was found to be nothing, but a simple financial transaction by which the lessee manipulated to mobilise funds at a lower rate of interest by passing on the benefit of depreciation to the lessor, for an asset which was never in existence at all. AO needs to scrutinize documents such asforged invoices, installation certificates, and valuation certificates with a view to establishing the non-existence of assets.

5.4.2 Over-invoicing of an Asset

In order to claim the depreciation at a higher rate both the lessor and supplier/ seller of the asset may enter into a collusive transaction, whereby the invoice value of the asset is enhanced and shown at a price disproportionate to the market value of the asset. Such transactions are usually resorted to, in case of transfer of the used assets. This kind of an arrangement is often seen in Sale and lease back transactions. Inspite of insertion of Explanation 4A by Finance Act, 1998 provisions of the Act are still exploited by unscrupulous tax payers.

5.4.3 A Single Asset Leased out to Multiple Lessees

In certain cases, the depreciation claim is preferred in respect of an asset which happens to be genuine and the value at which it is purchased by the assessee is correctly reflected but the same is sold to more than one party (mostly finance companies) and was often taken back on lease by the supplier of the said asset. Such transactions result in multiple claims of depreciation on the same asset. Such a transaction is more difficult to detect in enquiry regarding the existence of the supplier, price at which the asset is purchased, existence of the lessee as well as asset beside its value may draw an affirmative response in the favour of the assessee. Enforcement action such as Survey under Section 133A and Search under Section 132 of Income-tax Act, 1961 will help create evidences/ claim documents suggesting that some assets were sold to more than one person and subsequently taken back on lease by the same entities.

5.4.4 Sale and Lease Back Transactions

Manipulative transactions in Sale and Lease Back Transactions is a collusive one whereby the seller of the asset gets the asset back on lease for its own use and the purchaser of the asset leases out the same to the seller in accordance with the preexisting arrangement agreed to at the time of sale of the asset itself. This kind of an understanding between the two parties concerned implies that there is a certain level of proximity and closeness between the two entities. The practice adopted for evading tax in such transactions involves selling and leasing back of bogus or non-existent assets or assets which are not in a usable condition because of sheer lapse of time and continued use of the same by the seller over a sizable period.

5.4.5 Tests to be Applied for Examining Lease Transactions

In order to allow assessee's depreciation claim on the assets leased out, the following points need to be scrutinized.

a. Existence of asset during the relevant previous year;

b. Ownership of the asset during the relevant previous year;

c. Actual use during the relevant previous year;

d. A valid transfer in the eye of law;

e. Reflections on correct value;

f. Reflection of sale in books of account of seller (In this connection, one can check whether the alleged seller has paid sales-tax on the sale of the asset, or has claimed exemption from sales tax on the ground that it was not a Sale but only a financial transfer).

5.4.6 The Sale and Lease Back Transactions/ Lease Transactions where Assets are Non-Existent

The sale and lease back transactions/ lease transactions where assets are non-existent, finance and leasing companies were resorting to large scale tax evasion when manufacturing concerns approach them for working capital as loan. Instead of directly financing these leasing companies, insist manufacturing concerns to forge documents as if they are actually selling assets. In this arrangement finance and leasing companies get benefitted by claiming depreciation on the non-existent assets and manufacturing companies gets funds for their requirement. This kind of arrangement can be detected by verifying the bonafides of the manufacturers and suppliers of the said machinery and also enquiries are required to be made in the factory premises of these concerns.

Investigations also reveal another phenomenon in which the same is sold to 5–6 finance companies and taken back on lease. In this kind of transaction, the persons/ concerns own machinery which is generally hypothecated/ secured to financial institutions or banks. In effect, this amounts to non-existence of machinery since the same items cannot be sold more than one person/ concern.

In the above stated instances the tax treatment is that depreciation claimed thereon is required to be disallowed. However, the assesse may be eligible to claim a deduction of these alleged rentals offered as income. Since it is in the nature of finance transactions (and the leasing company always borrows substantial interest bearing funds from bank and financial institutions), interest calculated on IRR method has to be calculated in the same manner as interest is charged by them on financial transactions and bring the same to tax. Claim of the expenditure involved in the bogus lease to be dis allowed as non relatable to the business.

5.4.7 Sale and Lease Back Transactions where the Assets are Not Identifiable/ Tangible

It has been noticed that certain finance and leasing companies have been found to be engaged in sale and lease back transaction in respect of certain assets which are not clearly identifiable/ tangible like air conditioning systems (ducts, vents and other electrical connections but not central air conditioning plant), electric poles (without identifying them) certain items of machinery embedded in the ground (the transfer of such assets by an invoice without transferring the land) etc. In this type of cases, an asset which is a movable property is not capable of being transferred or identified. Also the market value of these assets, at the time of the lease transaction is almost impossible to ascertain even though the leasing is a way of business the legal position on this kind of transaction is not all that clear.

Suggested lines of enquiry in such case-It may be necessary to verify the:

a. Genuineness of transaction and the concern shown as manufacturing the asset. Examination of the invoice, Installation and commissioning, valuation Report, transportation documents, Insurance Documents and verification of check post stamps.

b. Physical verification and identification of asset (Makers reference No. etc.).

c. Verification of the bank accounts of the alleged supplier/ manufacturer with

particular emphasis on movement of amounts received as sale proceeds.

d. Verification of Books of accounts of concern which had sold and taken asset back on lease.

e. Reference to valuation Engineers if deemed fit.

5.4.8 The Sale and Lease Back Transactions/ Lease Transactions where Assets are Very Old/ Obsolete

In this type of transactions the machinery is found to be totally valueless or substantially less than the invoice price. To ascertain the correct market value it is necessary to refer these cases to Departmental Valuation Officer (Mechanical Engineers) for ascertaining the actual cost as referred to Explanation 3 to Section 43(1). Accordingly, the excess depreciation claimed is to be disallowed.

5.5 Cross-border Hiring of Machinery & Equipments—Transfer Pricing Perspective

Apart from the international transactions of purchase and sale of raw materials and finished products, provision and receipt of services, lending and borrowing of money, etc, assessees in India enter into the transactions of hiring of machinery, equipments, dredging vessels, etc, owned by their Associated Enterprises (AEs) situated in different geographies with differential tax rates. The Transfer Pricing issues that emanate from such transactions are discussed hereunder.

5.5.1 Categories of Assessees who are Likely to have Such Transactions

Companies which are engaged in carrying out big infrastructure projects like creation of metro rail network, exploration of oil and other minerals in sea and lands, dredging, provision of chartered services for transportation of passengers and goods through various modes like aircraft, helicopters, ships, etc, are likely to have international transactions with their AEs for hiring of machinery, equipments, dredging vessels, aircrafts, etc.

5.5.2 Transfer Pricing Issues in Hiring

When their AEs are situated in low/ NIL tax jurisdiction, the Indian assessees might tend to shift their profits to their AEs by following one or more of the following methods:

i. Paying hire charges at more than market rates for the equipments really needed

ii. Paying hire charges, at market or more than market rates, for the equipments that are not at all needed, i.e., hiring more than the requirement for the project

iii. Paying hire charges, at market or more than market rates, for the equipments that are needed but for periods more than the requirement for the project

iv. Paying hire charges, at market or more than market rates, for the equipments that are not at all needed, that too for periods more than the requirement for the project

v. Paying booking charges which will be less than normal hire charges for the equipments that have become technologically obsolete

vi. Paying hire charges, at market or more than market rates, for the equipments that are not at all used by the assessee but used by the third parties in India for which they also pay directly to the AEs.

The Indian assessees might resort to the practices at serial numbers 2 to 5 above when the machinery and equipments would otherwise remain idle with their AEs. In respect of transaction at Sl. No. 5, the assessees might, in order to avoid questions on lack of movement of machinery, claim that they have blocked it expecting a project.

5.6 Points for Investigation

i. In order to ascertain the need for hiring, machinery capacity needed and the duration for which they are needed, full details of the project/ work undertaken by the assessee to be ascertained. This includes the agreement signed by the assessee with the organisation which has engaged the assessee to carry out the project/ work. This will enable the TPO to know the duration, quantity and description of the needed machinery.

ii. Full details of the machinery/ equipment/ vessel hired, *viz*, description, model, type, size or capacity, serial number, name of manufacturer, year of manufacture, modifications or renovations from the standard, AEs identification of the asset (i.e. asset no. in the fixed assets register), etc, should be gathered. The above details will enable the TPO to find out, apart from the genuineness of the transaction, the comparables and the Arm's Length Price (ALP).

iii. The actual details of movement of the machinery, i.e., port of dispatch and port of landing, and the origin of invoice (if different from port of dispatch, unless it was stationed there due to previous work order) will help to unravel the profit shifting motive, if any. The port of landing and its further movements, along with log book/ installation details, will help to find out the actual usage.

iv. Sometimes the AE may not be the owner of the machinery and they could have been hired by the AE. Examination of the financials of the AE will provide information about the ownership and written down value of the machinery. The above details will assist in determining the ALP for the lease.

v. The copies of bills submitted by the assessee for claiming the payments due to it from the organisation which has entrusted the project/ work to the assessee should be obtained. This will enable to find out the actual extent of work done and the need for continued hiring of the machinery.

vi. Sometimes the high value machinery hired could have been specially designed to suit the requirements in India and it may not be useful for any other work anywhere. So, it is in the nature of consumbales. In such cases, the cost (along with finance cost for the duration of the project) of the same to the AE may be ascertained to analyse the extent of profits enjoyed by the AE by providing the same on hire basis.

vii. Details of amendments, if any, to the lease agreement should be ascertained along with the need for the same. This will enable to know whether there is any attempt to shift the profits by tweaking the terms and conditions in favour of the AE in the middle of the lease period.

If the required information from abroad is not furnished by the assessee, they may be gathered through Exchange of Information route.

5.7 TPO's Approach towards the T.P. Study of the Assessee: Generally the assessees benchmark this transaction by adopting Comparable Uncontrolled Price (CUP) method. But mostly they do not furnish required documentation of comparable prices to substantiate the Most Appropriate Method (MAM) of CUP chosen by them. In the case of an assessee providing aircraft charter service, under CUP method, it compared the lease rental payments for the flights hired by it from its AEs with the monthly financial cost, i.e., interest @ 6.15% and monthly depreciation cost of the comparables. This had to be rejected since no comparable lease rentals offered by other companies were furnished. However, TPO can independently explore the possibility of getting CUP data by invoking Section 133(6). In a

case of hiring of dredgers, the prices certified by Bureau Veritas, based on the Construction *Industry* Research and Information Association (CIRIA) industry norms (which use standard methods to establish the rates of various dredgers of the specified capacity, structural strength, equipment reliability and size of the dredgers and vessels on an annual basis), claimed by the assessee under "other method" was accepted. When such methods claimed by the assessee are not substantiated with documentation, TPO can proceed to benchmark by adopting Transactional Net Margin Method (TNMM), by comparing the net margins of comparable companies engaged in similar functions as the assessee with that of the net margins of the assessee and proposing adjustment to make good the deficiency in the assessee's margins. But it has got its own challenges. As these high value equipments are used for specific purposes, identifying the comparables is a difficult exercise. Further the assessee will be claiming economic adjustments in view of the huge lease rental payments incurred by it which may not be present in the case of comparables, if they own the machinery. Since the business model of the comparables is different, suitable adjustments, if required, may be considered taking into account the depreciation and finance cost of the self-owned machinery.

The international transactions in the nature of hiring of machinery, equipment, etc, between an Indian assessee and its foreign AEs are legally permissible. Sometimes they are inevitable since the kind of machinery required for complicated infrastructure and mining works are simply not available in India. e.g. Tunnel Boring Machines (TBM) used in metro rail network. But due care needs to be taken to ensure that the transactions happen at ALP in order to get the due tax from the Indian assessee, which, as a subsidiary of an MNC, will be eager to shift its profits to the no/ low tax jurisdictions.

5.8 Hire Purchase Finance Transactions Camouflaged as Lease Transactions

Hire purchase companies while advancing moneys to small operators for purchase of trucks/ buses/ vans draw a lease deed and obtains the signatures of the hirers (showing them as lessees). The actual transaction of the hire purchase is documented as lease. The modus operandi is that when a truck operator approaches for finance they collect margin money and documentation charges. The difference between the cost of the truck/ van/ bus and the margin money is financed by these companies charging interest between 13 to 16% depending on the period of repayment. The principal and the interest thereon is generally collected in equated monthly installments. On the payment of the last instalment the vehicle shown as leased out becomes the property of the alleged lessee. Further, the vehicles are registered in the names of the alleged lessees with endorsement favouring the leasing company. It is clear from the above that the alleged lessees have actually purchased the vehicles by availing finance from these concerns and that they have paid interest on the amount financed. It is true that most of these alleged lessees do not claim depreciation since they are not assessed to tax. Further, in a few cases where they are marginal assessees they can avail the provisions of Section 44 AE of the Income-tax Act and file their returns of income accordingly. In either case, they do not claim the depreciation since it is of no use for them.

For ascertaining the truth in respect of these transactions the following enquiries are required to be made.

a. The books of accounts of these leasing companies particularly lease account ledgers are to be examined for ascertaining as to how these transactions are recorded in their own books.

b. Enquiries are required to be made with the alleged lessees particularly with a query as to whether they are the real owners of the vehicles or not.

c. The registration certificate (RC books) issued by the Road Transport Authorities and the Insurance documents are to be examined.

d. Wherever the alleged lessees are assessed to tax and their assessment records are to be seen.

6. CONCLUSION

It is incumbent on the investigators to study the business model, work and information flow, records maintained by personnel involved in the business operations with a view to zero in on normal transactions. Persistent and diligent scrutiny of account books including digital evidence, bank accounts, will help identity points/ areas for further probe. Close scrutiny of such discrepancies juxtaposed with various regulators and evaluated as per the provisions of the Income-tax Act, 1961 will help bridge the tax gap that exists in this sector.

CHAPTER

7

Taxation of Non-Residents & Issues of Taxation in Case of Foreign Companies

1. INTRODUCTION

International taxation is the study or determination of taxes for persons who are subject to tax laws of multiple countries at the same time. When a taxpayer e.g. a non-resident Indian or a multinational company has its interests or businesses spread across multiple jurisdictions, then a separate and specific understanding of the tax implications in such cases, as against the case of taxpayers who are resident in India, is needed to ensure avoidance of double taxation and prevention of fiscal evasion due to multiple tax jurisdictions coming into play.

Assessment in international taxation charges involves cases of persons who are classified as non-residents as per the Income-tax Act, 1961 ('the Act'). While these cases involve all category of persons as defined in Section 2(31) of the Act, majority of the cases are cases of individuals, foreign companies and a smaller fraction comprises of cases of trusts. The major differences between assessment of non-residents and residents are:

a. Taxation of income received or deemed to be received in India or accruing or arising or deemed to accrue or arise in India in case of non-residents as against taxation of all income (whether in or outside India) in case of non-residents.

b. Applicability of Sections of the Act and involvement of issues which are not applicable to resident assesses

c. Taxation of some receipts on gross basis and applicability of specific rates of taxation

d. Applicability of the provisions of Double Taxation Avoidance Agreement (DTAA) to the extent that the same are beneficial to the assessee.

2. GENERAL CONCEPTS—CHARGE OF INCOME, SCOPE OF INCOME, INCOME DEEMED TO ACCRUE OR ARISE IN INDIA AND RESIDENTIAL STATUS

2.1 *Section 4* is the charging Section in the case of both residents and non-residents. As per the same, the total income of the assessee is charged to tax in accordance with the Act. Section 4

provides that Income-tax is to be charged at rate(s) enacted for any assessment year and such rate(s) shall be charged in accordance with and subject to the provisions of the Act in respect of the total income of the previous year of every person. This brings into play the provisions of the Act regarding the computation of the total income.

2.2 The *scope* of income for non-residents is defined in *Section 5(2)* of the Act. For residents all income without any territorial restrictions or requirements is taxable in India. However in case of non-resident, nexus of the income to India is necessary for the same to be chargeable to tax in India.

2.2.1 Section 5 in effect determines the scope of total income, which is mentioned in Section 4. In the case of a non-resident, total income includes all income from whatever source derived which:

i. Is received in India Section 5(2)(a), or

ii. Is deemed to be received in India Section 5(2)(a), or

iii. Accrues or arises to him in India Section 5(2)(b), or

iv. Is deemed to accrue or arise to him in India Section 5(2)(b).

Thus, total income of a non-resident can consist of income from *any source* that is derived by way of any of the above-specified four modes. In the case of sailors and persons who are non-resident under Section 6 but whose income, from whatever source derived, is received in India, only the provisions contained in Section 5(2)(a) as pertaining to receipt of income in India are of relevance.

2.3 As discussed, Section 5(2)(b) provides that income deemed to accrue or arise in India to a non-resident will be taxable in India. *Section 9* further specifies the incomes that shall be deemed to accrue or arise in India. For instance, royalty payment by a resident entity to a non-resident company would be taxable as income deemed to accrue or arise in India in the hands of non-resident entity, as per Section 9(1)(vi) of the Act.

2.3.1 Again Section 9(1) of the Act also provides that all income accruing or arising whether directly or indirectly through or from any "business connection" in India or through or from any property in India or through or from any asset or source of income in India shall be deemed to accrue or arise in India. The Section also provides for a reasonable attribution of income to the activities conducted in India. The Section also excludes certain activities of preliminary nature like purchase of goods for export, collection of news and views by a person running news agency etc. as not constituting business connection. Income of other nature such as royalty, fee for technical services etc. is similarly dealt with in Section 9(1) of the Act.

2.4 In case of assessment of non-residents, the first step is verification of residential status as per *Section 6* of the Act. As discussed earlier, this is an important step, because based on whether an assessee is resident or a non-resident, its entire income or part of income will be taxed in India. For instance, for individuals, this would be based on the number of days of stay in India as per Section 6(1) of the Act. Similar criteria are provided for other category of persons as well.

2.5 However, even when an assessee is held to be a non-resident, Section 4, 5, and 9 are not sufficient to determine charge and for computing income liable to taxation in India. Section 5(2) has subjected this scope of Total Income to the provisions of the IT Act. It therefore needs to be examined what provisions of the Act will be of relevance for Section 5(2).

2.5.1 Computation of total income is to be made in accordance with provisions contained in Chapter IV of the Act. In this regard, Section 14 provides that unless it is provided otherwise, all income *shall*, for the purposes of:

i. *Charge* of Income-tax and

ii. *Computation* of total income,

be classified under the heads of income 'Salaries', 'Income from House Property', 'Profits and Gains of Business or Profession', 'Capital Gains' and 'Income from Other Sources'. Thus, any item of income must fall under one of these heads of income in order to be chargeable, and for the purpose of computation of total income.

2.5.2 Therefore even in case of non-resident assessee, the first step involves the characterisation of income–under what head of income it can be put. For instance, if the income is of the nature of salaries and it is to be placed under the head "Salaries", for chargeability of income under this head and for its computation, the provisions contained in Chapter IV-A of the Act shall apply. Similarly for an income in the nature of *Profits and Gains of Business or Profession* Section 28 is the charging Section and the method of computation is determined by the provisions contained in Chapter IV-A of the Act.

2.5.3 There are some provisions e.g. Section 44B, Section 44BB etc., that provide for both charging and computation separately. For instance, Section 44B which is *Special provision for computing profits and gains of shipping business in the case of non-residents* begins with the expression *'Notwithstanding anything to the contrary contained in Section 28 to 43A…'*. Therefore it excludes both the charging Section 28 and the computation machinery provided by the subsequent Sections. It provides for both charge and computation of income in case of a non-resident engaged in the business of operation of ships on presumptive basis. However, as held by the Hon'ble Supreme Court in the case of *Sedco Forex International Inc vs. CIT* and others (Civil Appeal No. 4906 of 2010 and others), Sections 4, 5 and 9 of the Act which deal with charging Section, total income and income of non-resident which arises or deems to arise in India cannot be sidetracked even in cases where the income is covered by Section 44BB.

2.5.4 Thus the general charging Section, Section 4 of the Act, provides charge of Income-tax for the '*Total Income*' of a person and 'total income' gets defined in Section 5 of the Act. In doing so, Section 5 defines total income to include not only income accruing or arising etc. 'in India', but also any income accruing or arising from whatever sources derived anywhere *outside India* in case of a 'resident', but in case of a 'non-resident', it only uses the words 'in India'. *The impact of this is two-fold*. *First,* Section 4 gets inextricably and intrinsically linked to Section 5, and *second,* the charging Sections under different heads get precluded from including the word 'in India' as it would prevent the charge of income accruing or arising from anywhere outside India in case of residents. It is only by virtue of Section 5 that the separation is made in case of residents and non-residents. *Both these Sections in turn are linked with Section 14 of the Act*, which provides that there has to be a separate charge for income classified under each of the five heads of income and also for computation of 'total income'. Thus, Section 14 also links charge and total income together, thereby bringing Section 5 into play. These Sections and the manner of applying the same is further discussed below while dealing with the two most commonly faced issues while taxing income of non-residents–claim of benefit under Section 54 and taxation of salary of non-residents on receipt basis.

3. ISSUES OF TAXATION IN CASE OF NON-RESIDENT (OTHER THAN COMPANIES)

3.1 Taxation of Non-Residents Salaries on Receipt Basis Under Section 5(2)(a) of the Act

3.1.1 In cases where any of the DTAAs entered into by India is not applicable (either for the reason there being no treaty with a country where the person earning income is resident or the person not fulfilling the conditions set in the DTAAs for residence in order to claim treaty

relief entitlement) only the provisions of the Act are applicable. In such cases, generally speaking, salary earned outside India but received in India in case of non-resident individuals has always evoked differing reactions.

3.1.2 As discussed earlier, Section 4 provides for the charging of income to tax and Section 5(2) of the Act determines the scope of total income chargeable to tax in the case of non-residents which is income *received or deemed to be received in India by or on behalf of the assessee or accrues or arises or is deemed to accrue or arise in India.* Thus, total income of a non-resident can consist of income from *any source* which is derived by way of any of these four modes. In the case of sailors and persons who are non-resident under Section 6 but whose income, from whatever source derived, is received in India, only the provisions contained in Section 5(2)(a) as pertaining to receipt of income in India are of relevance.

3.1.3 As already discussed extensively, Section 5(2) has *subjected* this scope of Total Income to the *provisions of the IT Act.* Section 14 provides that unless it is provided otherwise, all income *shall,* for the purposes of *charge* of Income-tax *and computation* of total income, be classified under the heads of income 'Salaries', 'Income from House Property', Profits and Gains of Business or Profession', 'Capital Gains' and 'Income from Other Sources'. Thus, any item of income must fall under one of these heads of income in order to be chargeable and for the purpose of computation of total income.

3.1.4 Thus the first step is ascertaining the nature of income and under what head of income it can be placed. If the income is of the nature of salaries and it is to be placed under the head "Salaries", for chargeability of income under this head and its computation, the provisions contained in Chapter IV-A of the Act shall apply.

3.1.5 Section 15 of the Act is the *charging Section* for income under the head 'Salaries'. In this context, the following are regarded as *chargeable:*

i. any salary due to an assessee from an employer in the previous year, whether paid or not; Section 15(a)

ii. any salary paid or allowed to an assessee in the previous year by or on behalf of an employer, though not due or before it became due; Section 15(b)

iii. any arrears of salary paid or allowed to an assessee in the previous year if not charged to tax for any earlier previous year. Section 15(c)

3.1.6 A plain reading of Section 15 suggests that salary becomes chargeable on *due basis,* even if it is not paid by the employer. However, it can be charged to tax on receipt basis also. But this could be done only in cases where the salary is received before it is due or has not become due at all. The case under consideration here pertains to Section 15(a) of the Act.

3.1.7 In such cases, appellate authorities and different High Courts have taken a view in the past that if salary has become due to the assessee overseas, it cannot be charged to tax in India on receipt basis because the income has *accrued or arisen* (i.e., has become due) to the individual outside India.

3.1.8 Apparently, the main point of contention here, is whether the language of the statute as contained in Section 15(a) reflects any locational preference. There is no such preference in Section 15(a). Salary can become due to an 'assessee' anywhere in the world. The moot question here is the meaning of the phrase *'due from an employer … whether paid or not'*. This phrase was present in Section 7(1) of the 1922 Act also. Hon'ble Supreme Court of India had occasion to determine the meaning of this phrase in the case of *CIT vs. L.W. Russel* (1964), 53 ITR 91(SC). Hon'ble Apex Court held that:

> *"The expression "due" followed by the qualifying Clause "whether paid or not" shows that there shall be an obligation on the part of the employer to pay that amount and a right on the employee to claim the same."*

Thus, as explicitly determined by the Hon'ble Apex Court, the term "due" as qualified by the phrase "whether paid or not" is connected with the contractual right of the employee to receive his salary and nothing else. It has no relation with location or place of services rendered, or to where the amount has become "due". Thus, what is important for charging an amount to tax under Section 15(a) is whether it is in the nature of salary and whether it has become due to the assessee (whatever may be his status–resident or non-resident) and it has no relation to the place where it has become due. The place where it has become due, and the place where service has been rendered, do not form a basis of charge under Section 15 of the Act. Had the Parliament thought it relevant, the statute would have taken a form that reflected such thought.

3.1.9 This is also borne out by the phraseology of the charging Sections for all other heads of income. Thus,

i. in case of the head "income from house property", the charging Section 22 mentions that 'the annual value of property consisting of any buildings or lands appurtenant thereto of which the assessee is the owner, other than such portions of such property as he may occupy for the purposes of any business or profession carried on by him the profits of which are chargeable to Income-tax, shall be chargeable to Income-tax under the head "Income from House Property'.

ii. In case of the head of income "profits and gains of business or profession", the charging Section 28 mentions that the 'following income shall be chargeable to Income-tax under the head "Profits and gains of business or profession",—

iii. the profits and gains of any business or profession which was carried on by the assessee at any time during the previous year; …

iv. In case of the head of income "Capital Gains", the charging Section (Section 45) mentions that 'any profits or gains arising from the transfer of a capital asset effected in the previous year shall, save as otherwise provided in Sections …. be chargeable to Income-tax under the head "Capital Gains" and shall be deemed to be the income of the previous year in which the transfer took place'.

In case of the head of income "Income from Other Sources", the charging Section (Section 56) mentions that 'income of every kind which is not to be excluded from the total income under this Act shall be chargeable to Income-tax under the head "Income from Other Sources", if it is not chargeable to Income-tax under any of the heads specified in Section 14, items A to E'.

It can be seen that any of these charging Sections for respective heads of income do not mention that the location of the income should in any way be in India. There is no condition that the income should 'accrue or arise' in India.

3.1.10 The reason for this is not far to fathom–it is intrinsic to the charging Section for the Income-tax Act, 1961. Section 4 does not mention that the charge is for income accruing or arising only in India. Hence, the charging Sections for respective heads of income are foreclosed from using any different phraseology. The Act has been made to tax global income of residents. In case of non-residents, the scope of total income has four modes, one of which is receipt in India, 'from whatever source derived'. If this construed to mean only accruing or arising in India, then Section 5(2)(a) will become a subset of Section 5(2)(b) and there would not be any need for having Section 5(2)(a) on the statute.

3.1.11 The arguments in this regard are summarized as follows:

i. As mentioned above, the place where the salary has become due or the place

where service has been rendered has no relevance so far as charging of tax on salary under Section 15 is concerned. This is based on a plain reading of the statute and the decision of Hon'ble Apex Court cited above.

ii. As the assessee is a non-resident, once it is determined that the income is of the nature of salary and it has become due to the assessee, the conditions laid down by Section 15(a) get fulfilled and it only remains to be seen whether it falls within the scope of total income as provided in Section 5(2) of the Act. As mentioned earlier, in the case of a non-resident, any income from whatever source derived, is to be included in his total income if it is received in India Section 5(2)(a) of the Act. Accordingly, the salary of such non-residents received in India will be taxable in India.

iii. Charging Sections-either 4 or separate ones for different heads neither have nor can they have geographical nexus, because we have to tax global income in general.

iv. Section 5(2) mentions 'all income from whatever source derived' in case of non-residents. So first there has to be income. If such income is of the nature of salaries, it is to be taxed under Section 15 of the Act. The view that income should accrue or arise within India, has no mooring in Section 15, or any other charging Section.

v. Once it is chargeable under the Act under Section 15, then in case of non-residents, we have to see under which limb it has to be placed–when it is received in India it falls under Section 5(2)(a).

vi. If we remove the above interpretation, then no other meaning can be attached to the expression 'received in India'. If an income of non-resident can be taxed only if it is accruing or arising in India, then 5(2)(a) becomes a subset of 5(2)(b) and therefore Section 5(2)(a) becomes superfluous/ redundant which cannot be the legislative intent.

3.1.12 Recently, by Circular No. 13 of 2017 dated 11/04/2017, CBDT has clarified that salary accrued to a non-resident seafarer for services rendered outside India on a foreign ship shall not be included in the total income merely because the said salary has been credited in the NRE account maintained with an Indian bank by the seafarer. However, as is evident this Circular is applicable for a specific category of taxpayers receiving salary in a specific type of bank account only.

4. DOUBLE TAXATION AVOIDANCE AGREEMENTS (DTAAs)

4.1 When assesses and their transactions and activities are spread across multiple tax jurisdictions (i.e. multiple countries) complex issues such as taxation of the same income twice may arise. A conflict may arise between two taxing countries if resident of one country earns income in another country. While one country may try to tax global income (residence based taxation), the other country may try to tax on the basis of place of accrual of income or economic substance (source-based taxation). This may result in taxation of same income by both counties. To address the same, Section 90 of the Act permits the Central Government to enter into Double Taxation Avoidance Agreements or DTAAs. The dilemma of double taxation is resolved through DTAAs entered into two by countries wherein taxation rights are assigned to the two countries. Thus while Sections 5 and 9 stress the right of the source country to tax income earned in that country, the DTAA eases the burden on the earner of income.

4.2 Broadly DTAAs have dual purpose-avoidance of double taxation due to jurisdictional overlaps of multiple countries and conflict between residence-based taxation (taxation of

income in the country of residence) and source-based taxation(taxation of income in the country where the income originates), and prevention of fiscal evasion by information sharing either through the automatic route known as Automatic Exchange of Information (AEOI) route or by providing information in response to specific references.

4.3 As per Section 90(2) of the Act, where India has entered into a DTAA with another country, provisions of the Act shall apply to the extent the same are beneficial to the assessee who is a resident of that other country. It is important to note that Treaty does not provide for the charge of income–that is only provided by the Domestic Law of a Contracting State. Thus income that is not chargeable to tax under the Act, cannot be taxed by way of Treaty. Alternatively, only once an income is taxable under the Act, can relief from taxation w.r.t. the same, be sought under the Treaty.

4.4 General Structure of a DTAA or Treaty

In a DTAA or Treaty, specific Articles provide for the applicability of the treaty, manner of sharing of taxation rights between contracting states, definitions, anti-avoidance provisions and elimination of double taxation. There are model tax treaties of the UN and the OECD and commentaries for the same. Most of the treaties are based on these models. As treaties have many terms that are broadly worded, their interpretation often requires aid of model commentaries (OECD & UN) and court decisions. While the Article numbers given below may vary as the same given below are for illustrative purposes (India-USA DTAA has been used for reference), in general tax treaties are structured in a similar manner with similar positioning of Articles. Some of the key Articles are discussed below:

4.4.1 *Article 1* of a Treaty states that the treaty shall apply to a person who is a resident of either of the contracting countries or both. Therefore treaty cannot be invoked if a person is a non-resident in both countries.

4.4.2 *Article 2* of a Treaty specifies the domestic taxes of the two countries to which the Treaty would apply.

4.4.3 *Article 3* of a Treaty gives the general definitions for terms in the treaty. This is a key difference between general international treaties and tax treaties. International treaties for instance the Treaty of Versailles, do not have a definition Clause and the terms therein are understood by their general meaning. Contrary to that, and overriding the Vienna Convention on Law of treaties, tax treaties have specific Articles dealing with definitions. These specific definitions of terms override their general meaning. *Article 3(1)* gives specific definitions of terms whereas *Article 3(2)* provides that for the interpretation of terms not defined in the treaty, domestic tax laws will be resorted to.

4.4.4 *Article 4* of a general Treaty defines who a resident of a contracting state is. It may happen that due to difference in provisions of domestic laws of contracting states, a person at a given time may become resident of both countries, and consequently issues, such as taxation of assessee's entire income or global income becoming taxable in both countries, may arise. To address such cases, tiebreaker rules are given in *Article 4(2),* so as to deem the person as resident of either one of the contracting states, but not both at the same time.

4.4.5 *Article 5* of a general treaty explains the term permanent establishment ('PE'). As per Section 9 (1) of the Act, one of the categories of incomes, deemed to accrue or arise in India is all income accruing from a business connection in India. However, as per *Article 7* of a treaty, profits of an enterprise of a foreign country will be taxable in India only if the said enterprise has a permanent establishment in India. It is this term permanent establishment that is dealt with in *Article 5* of a general treaty. The issue of permanent establishment is discussed in detail later. However, in brief, *Article 5* specifies a permanent establishment to be a fixed place

of business through which the business of an enterprise is wholly or partly carried on. Article 5(2) of the treaty gives an illustrative list of places or activities that are included in the term permanent establishment. Article 5(3), on the other hand provides an illustrative list of facilities or activities that shall be deemed to be not included in the term permanent establishment.

4.4.6 Specific Articles are provided for dealing with specific type of income. *Article 6* gives the country of residence right to tax income from immovable property (e.g. from agriculture, forestry).

4.4.7 As already discussed, *Article 7* deals with taxation of business profits. The taxation of business profits will only be done in the country of residence (i.e. the foreign country) unless the enterprise has a permanent establishment in India and vice versa. Thus for instance for a non-resident enterprise, its business profits will only be taxable in India, if it has a PE in India. More importantly, as per Article 7(1) only profits directly or indirectly attributable to such PE will be taxable in India.

Furthermore, as per Article 7(2) of the DTAA, the global enterprise i.e. the non-resident assessee(GE) and its PE in India will be treated as distinct and separate enterprises engaged in same or similar activities. Thus in effect, by virtue of this Article the PE and GE or the non-resident taxpayer become associated enterprises.

4.4.8 This concept is further extended to determination of transaction between these separate entities i.e. the GE and the PE at Arms Length Price (ALP) in Article 7(2). Article 7(2), prescribes the method of determination of the profits attributable to the permanent establishment of the enterprise of a Contracting State in the other Contracting State. This Article mentions that those profits should be attributed to the permanent establishment which:

i. it *might be expected* to make
ii. if it were a *distinct and separate* enterprise
iii. engaged in the *same or similar* activities
iv. under the *same or similar conditions*
v. and *dealing wholly independently* with the enterprise of which it is a permanent establishment.

Thus though the PE is legally not a separate entity, for the purpose of attributing profits to it, it has to be deemed as such. Further, the DTAA mentions that not only the PE has to be taken as separate entity, it has to deal with the enterprise i.e. GE, of which it is a PE, in an independent manner. Thus, the arm's length principle for transactions between Associated Enterprises which is separately embodied in *Article 9* of the DTAA in case of separate legal entities, is implied in case of a GE-PE situation on account of the phrase 'dealing wholly independently with the enterprise of which it is a permanent establishment' as mentioned in Article 7(2) of the DTAA.

4.4.9 *Article 8* deals with income from shipping companies and air transport. Due to the specific nature of these businesses, their activities are spread across multiple countries, and therefore in general the income from such companies are taxed in the country of residence.

4.4.10 Similarly, *Article 10* deals with dividend income, *Article 11* deals with interest income, *Article 12* pertains to royalties and fee from technical services and *Article 13* is concerned with Capital gains.

4.4.11 It is important to note here that in the tax treaties entered by India with other countries, the distributive rule i.e. giving rights of taxation to both the country of residence and the other contracting country applies. Generally the primary rate of taxation is given to the country of residence. In general specific paragraph in an Article uses the term *"shall be"* or "may be" and grants the right of taxation to the country of residence. When the right of taxation is also granted to the source country, such a secondary right is explicitly provided for and the specific

paragraph in the Article does that by using the term *"may be"* or "may also be". For instance, if a person is a resident of the foreign country and non-resident in India, as per Paragraph 1 of *Article 12* royalties and fee for technical services, will be taxed in the foreign country. However, as per Paragraph 2 of Article 12, royalties and fee for technical services will also be taxable in India. In some cases either the source state or the residence state may be given the only right of taxation. For instance, Article 6 gives the right of taxation of income from immovable property to the source country i.e. the country where the immovable property is situated. Similarly Article 13 allows both the contracting states i.e. the country of residence and source country to tax capital gains in accordance with the provisions of domestic law of both states.

4.4.12 Relief in cases of double taxation (when both the source country and the country of residence have rights of taxation on the same income) is provided by the foreign country in this case i.e. the country of residence. This is done by either of two methods-the credit method, or the exemption method. In credit method, while computing the tax liability of the person in the country of residence, the country of residence will allow credit to the taxpayer for taxes paid in the source country i.e. taxes paid as per Paragraph 2. In exemption method, the country of residence may forfeit its right to tax the said income, already taxed in the other contracting state, all together. India follows the credit method of granting relief from double taxation. The same is generally incorporated in *Article 25 (Relief from double taxation)* of the treaty.

4.4.13 The purpose of tax treaties is not only avoidance of double taxation but also prevention of fiscal evasion. Therefore specific anti-avoidance provisions are incorporated in the tax treaties. *Article 24* is the *limitation of benefits* article. This lays down additional restrictions/ conditions that need to be fulfilled to enable a person to avail treaty benefits. The said article aims to curb both transaction-based tax evasion (transaction designed to evade taxes) and entity-based tax evasion (entities floated with the sole purpose of availing treaty benefits). Therefore whenever, the applicability of treaty benefits under any Article is being examined, a reference must necessarily be made to the limitation of benefits provisions to examine whether there are additional restrictions/ conditions to be fulfilled for availing treaty benefit under the specific Article or treaty under consideration.

4.4.14 Similarly, a reference must be made to the *Protocol* provided at the end of the treaty. Protocols are agreements that diplomatic negotiators sign as basis of final treaty. The same contain additional qualifiers that must necessarily be read with the original treaty. For instance, Protocol to the India-USA DTAA contains a separate MoU concerning Fee for included services given in *Article 12* of the treaty, which deals elaborately with the said Article together with illustrations. Similarly Protocol to the India-Germany DTAA qualifies business profits from permanent establishment under *Article 7* of the India-Germany DTAA and specifically excludes the value of machinery or equipment, related to a building site or construction, assembly or installation project, delivered from head office or another permanent establishment to a permanent establishment in the non-resident country, from attribution to the profits of the building site or construction, assembly or installation project.

4.4.15 *Article 28* provides for *Exchange of information and administrative assistance.* Based on the terms agreed between the countries, it provides for exchange of information for assistance in assessment, collection of taxes, enforcement or prosecution.

5. ISSUES OF TAXATION IN CASE OF FOREIGN COMPANIES

5.1 Permanent Establishment

5.1.1 It is important to understand the concept of permanent establishment as embodied in

tax treaties to examine the issue of taxation of business profits of non-resident foreign companies, in India. The Indian I T Act, as well as the DTAAs contain provisions concerning income of different types. The general rule of interpretation is–the special provisions will over-ride the general provisions. Hence, if an income falls specifically in any of the Articles of DTAA–such as royalty or FTS or interest, it will not be liable to be treated as business income. For business income to be taxed in a jurisdiction, existence of connection between the income and activity performed in that jurisdiction is a must as specified in Section 9(1)(i) of the Act

In general, business profits of non-residents are taxable in India by virtue of *Section 9(1)* **(i)** which states that income accruing or arising through or from any *business connection* in India, or through or from any property in India, or though or from an asset or source of income in India or through the transfer of capital asset situate in India is deemed to accrue in India.

5.1.2 The term business connection is not defined specifically in the Act. But from the evolution of the concept through usage and through judicial decisions, in order to *constitute a business connection,* following conditions need to be satisfied:

a. *Real & intimate relation* must exist between trading/ commercial activities outside India and the activities within India.

b. The relation *contributes* directly or indirectly *to earning income* by the non-resident in his business.

c. The Continuity of relationship between activity outside and within India would be relevant for determining business connection.

5.1.3 It is clear from the above that a business connection connotes a wide range of relationships, which would invite taxation in the source state. This may lead to difficulty in conduct of normal trading businesses wherein even a single visit of the non-resident may result in his being liable to tax in source state.

5.1.4 In cases where assesses are non-residents in India but residents of countries with which India has no DTAA, the business income accruing or arising through or from a business connection in India will be taxable in India by virtue of this Section 9(1)(i) of the Act. However, in other cases where India has entered into DTAAs, to address this issue of double taxation, the concept of permanent establishment has been brought in through *Article 5* of DTAAs.

The *broad scope of business connection* as provided in Section 9(1)(i) of the Act, is *restricted* by the concept of *permanent establishment* embodied in DTAA. This is because where an assessee is a resident of a country with which India has entered into a DTAA, business profits in case of non-residents are taxable in India, only if there is a PE in India as per the DTAA, and not merely because a business connection exists as per Section 9(1)(i) of the Act.

5.1.5 Thus PE is a compromise between the two states with respect to taxation in favour of promotion of trade and commerce as it denotes a term *more concrete* and *ascertainable than a business connection.*

As already discussed in the introductory paragraphs of this Chapter, under *Article 7* of tax treaty, a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a 'PE' situated therein (exception being incomes otherwise taxable on gross basis, such as royalty, fees for technical services, interests etc). Thus concept of a PE is relevant for determining the right of a Source State (India in this case) to tax the Business Profits of the foreign enterprise covered by tax treaty.

5.1.6 Paragraph 1 of *Article 5* of Tax treaties broadly explains the term permanent establishment, as a fixed place of business

through which the business of an enterprise is wholly or partly carried out. (In this Section, for the sake of illustration, specific references to Paragraphs of Article 5 are Paragraphs as given in the model UN convention, the numbering and arrangement of Paragraphs may vary from treaty to treaty). However this definition is not rigid and is to be interpreted as per the facts of a case and will depend upon various factors such as the nature of business of the assessee, activities involved in the same, the mode of conduct of such business, level of expertise, skill required, terms of relevant agreement and contractual obligations of the assessee under the same.

Paragraph 2 and Paragraph 3 of Article 5 provides for *specific inclusions* by giving an illustrative list of what is included in the term permanent establishment (e.g. place of management, branch, office, building site or construction, furnishing of services in the contracting state etc.). Similarly, *Paragraph 4* of Article 5 provides for *exclusions* by giving an illustrative list of what is deemed to be not included in the term permanent establishment (e.g. use of facilities solely for the purpose of storage, display etc.)

5.1.7 However, the lists are merely indicative and not strictly compartmentalized definitions. Whether for a non-resident permanent establishment exists or not, can only be examined and established after thorough analysis of all receipts, documents such as contractual agreements, personnel of the GE deployed in India, nature of activities carried out or services rendered, risks and responsibilities assumed in India etc.

5.1.8 From the above discussion what emerges is, that to determine whether the *business profits of a non-resident enterprise are taxable in India,* two stages are involved. The first stage is *PE formation* i.e. ascertaining and establishing whether a PE of the non-resident exists in India. The second stage is *attribution of income to the PE,* that will be taxable in India.

5.1.9 Establishing the Existence of PE in India and Types of PE

Under the DTAA broadly there are the following 4 types of PE:

a. Fixed-place PE
b. Project PE
c. Agency PE
d. Service PE

5.1.10 Fixed-Place PE

5.1.10.1 Article 5(1) of the DTAA, defines PE as a *fixed place of business* through which the business of the non-resident is wholly or partly carried out. Examples of such places as included in Article 5(2) of PE include branch, office, factory, workshop etc. Thus under Article 5(1), PE exists if all the *following conditions* are satisfied cumulatively:

a. There is a *place of business* ("place of business test")
b. Such place of business is at the *disposal* of enterprise or the taxpayer must have a certain right of use over the fixed place of business ("disposal test")
c. Such place of business is *fixed geographically and it* must last for a *certain period in time* ("location test" and "permanence test")
d. The *business* of the enterprise is *carried on* ("business activity test") wholly or partly through such fixed place of business

5.1.10.2 Thus for ascertaining the existence of a fixed-place PE in a case, the existence of the above conditions must be verified from the facts of the case. The presence of the non-resident assessee through a PE should be visible in India and is usually linked to a geographical location. A geographical *location* that is *relatively stable* and under some degree of control of the assessee, and where at least some part of the *business activities* of the assessee are carried out, is indicative of the presence of a fixed-place PE.

5.1.10.3 The term *'place of business'* covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. Place of business may be created where certain amount of space is available even if the same may not be available for the exclusive use of the assessee. There must be geographical and commercial coherence.

5.1.10.4 *Fixed Place* of business implies that the place of business should have a certain *degree of stability* in terms of location and duration.

A PE *may exist* where there is a geographical link (locational test) although activities of enterprise are mobile over a geographical area in view of the specific nature of such activities. (e.g. Drilling activity).

5.1.10.5 A certain degree of permanence (Permanence test) is a feature of such a place of business. However, permanent *does not mean everlasting.* It is used in contra-distinction to something fleeting, transitory or casual.

5.1.10.6 The premise has to be *at the disposal* of the enterprise during the period (power of disposition). But legal right over the place is not necessary. Thus the *premise may be owned, rented or otherwise at the enterprise's disposal,* and fixed place does not denote owned premises. It is also not necessary that the foreign enterprise alone has the power of disposition. However mere presence would not constitute a fixed place.

5.1.10.7 The concept of fixed-place PE covers premises as well as tangible assets used for carrying on business. Human element is not a necessary criteria for establishing a fixed place of business. Hence, a server/ machinery/ equipment may be treated as place of business depending upon the nature of business. Para 17 of the OECD Model Commentary states that a PE may exist if the business of the enterprise is carried on mainly through automatic equipment and the activities of the personnel are restricted to setting up, operating, controlling and maintaining such equipment; thus, *even existence of a computer server* may amount to existence of a PE within a jurisdiction.

In a case in US involving participation of a non-resident person owning a racing stable in a horse race, the existence of a racing stable was treated as a fixed place of business giving rise to a PE.

Thus depending on how important a *role the place of business plays in the conduct of business activities* of the assessee, such place of business may be treated as a fixed-place PE.

5.1.10.8 For satisfying the *permanence condition or duration test,* availability of a fixed place of business for a reasonable period is to be examined. Thus an isolated activity will not lead to establishment of a fixed base PE as the ingredients of *regularity, continuity* and *repetitiveness* are essentially missing. However, if the nature of business is such that it can be carried out only for short period(e.g. car race), it will create a PE. Thus *short duration activities* can constitute a PE depending upon the *recurrence* of the activities and *nature of business* as held in the case of Formula One World Championship Limited (2017) TS-161-SC-2017.

A PE *commences* or comes into existence as soon as the assessee commences business through the premise.

A PE will *cease to exist* if business is no longer carried, fixed place of business is disposed off and all the connected activities of business are stopped (temporary interruptions in running business are not to be considered).

5.1.10.9 It is also important to examine the nature of *business activities* being carried out at these premises. The foreign entity must carry out its own business activity (partly or wholly) through the PE. The business activity should also *relate to the income sought to be taxed.* The business activity must *not* be of only preparatory or auxiliary character. The

activities should be part of the core business of the taxpayer i.e. it should contribute to earning of income of the non-resident (income generating activities).

Activity need not be of "productive character" but it should be connected to core activity– i.e. the PE should contribute to the business earnings. Thus activity test could be satisfied, by having personnel or automatic equipment at fixed place.

5.1.10.10 *Paragraph 8* of Article 5 specifies that a *subsidiary company* on its own will not constitute a PE of a non-resident company. Thus, ordinarily, a subsidiary would normally not constitute a PE. However, a subsidiary may be taken as constituting a PE for the non-resident, if it *renders significant activities on behalf* of the non-resident.

5.1.11 Project PE

5.1.11.1 Project PE defined in *Paragraph 3* of Article 5, comes into existence in cases of construction or installation projects. A building or construction or installation project constitutes a PE if it lasts *over a designated period* (6 months, 120 days etc. depending upon the specific DTAA).

5.1.11.2 Paragraph 3 specifies that the term 'permanent establishment' encompasses *a building site, a construction, assembly or installation project or supervisory activities in connection therewith*. The term *building site or construction or installation project* includes not only construction of building but also construction of roads, bridges, canals, laying of pipe lines, excavating and dredging. It can also covers demolition and clearing operation and installation of new plant & equipment in place of existing one. Renovation work, that is more substantive than mere maintenance or redecoration of buildings, roads, bridges or canals etc., can also be included in this definition. Planning and supervision of these activities are also covered in this definition.

5.1.11.3 As with fixed-place PE, for project PE as well, seasonal or other temporary interruptions are included in determining the life of the project. Time spent in relocation of project/ office would also be included in determining the life of the project. It is irrelevant whether the prolongation was unexpected as was caused by geological or other difficulties. It also makes no difference to the time test whether the activities in question *extend over more than one assessment year* (This issue is discussed in detail later).

Due to the very nature of contract, there may be relocation of project office (road contracts, dredging activity) such shifting is usually immaterial for purpose of computing construction PE as the business activities continue.

It may also be noted here that Article 5(3) overrides Article 5(1), being a special provision.

5.1.12 Service PE

5.1.12.1 Service PE is also defined in *Paragraph 3 of Article 5* of the DTAA. Furnishing of services, including consultancy service, through employees or other personnel of an enterprise of one of the states constitutes PE in the state where the services are performed. Similar to Project PE, it is to be seen that these services are performed for more than specified time period (the period is different for each DTAA). The services can be provided in a number of ways e.g. they may be provided by the presence of the personnel of the non-resident enterprise or through employees of related Indian party.

5.1.12.2 Again the criteria of services being part of core business activities and not preparatory and auxiliary in nature is applicable w.r.t. service PE as well.

5.1.13 Agency PE

5.1.13.1 *Paragraph 5 of Article 5* specifies a person acting on behalf of the non-resident assessee as PE in India as dependent agency to be deemed as PE of the non-resident if it performs the following functions:

a. Habitually exercises *authority to conclude contracts,* or

b. Habitually maintains stock of goods or merchandise from which regular deliveries are made on behalf of the foreign enterprise, or

c. Habitually *secures orders wholly or almost wholly* for the foreign enterprise or enterprises controlled by the foreign enterprise

As already specified brokers, general commission agents or other agents of independent status i.e. who are acting in their regular course of business, are not counted as dependent agents. This exception is provided for in *Paragraph 7* of Article 5 of the DTAA. Again this exception would not apply in case where:

a. Activities of such persons are *devoted wholly or almost wholly* on behalf of that enterprise and

b. Transactions between agent and the enterprises were not made at arm's length conditions.

5.1.14 Avoidance of PE

Non-residents attempt to structure their business in such a way so as to avoid constitution of a PE. For instance, for activities falling within the definition of Service PE, the attempt is to ensure that the duration tests are not satisfied. For other activities, assistance of local parties may be taken to ensure or give the appearance that no physical presence can be established. The tools of business allowed by internet has allowed non-residents to control their businesses remotely, thus avoiding a permanent establishment.

5.1.15 Issue of Composite Contracts and Determination of PE

A key issue that is disputed in the case of Project PE is the composite nature of such contracts or projects where elements of both onshore services (e.g. supervision, testing) and onshore supply (e.g. supply of minor spare parts) as well as offshore services (training outside India, design) and offshore supply 6 (supply of plant and machinery from outside India) are involved.

At times, the non-resident assessee itself is dealing with all 4 aspects but by way of separate agreements. In other cases, it may enter into a consortium arrangement with an Indian entity, usually a related party, which deals with the onshore elements of the contract. The assessee in both these scenarios, often claims that the offshore supply and at times even offshore services are not taxable in India as the same are rendered outside India (Some assessees may offer offshore services as FTS separately on gross basis, but offshore supply is still treated by them as non-taxable).

This is one of the most widely used methods to avoid PE. Thus such a splitting-up of contracts by the non-resident assessee or between closely related enterprises results in absence of the main contractor from the tax jurisdiction where the contract is being executed. Splitting may at times also results in the enterprise failing the duration test.

In all such cases it is important to go through the terms of the contracts carefully, including all related MoU, tender documents, bid documents, amended contracts. It has to be determined whether the non-resident assessee either through its own presence as a Project PE or its Indian related party is assuming risks and responsibilities in India under each individual contract, that is disproportionate to the remuneration it is receiving i.e. assuming responsibilities for offshore elements of the contract as well while receiving payments for only the onshore elements. In such cases, the possibility of the non-resident assessee having a Project PE in India for the entire contract including offshore elements needs to be examined. Most of such contracts would also have a *cross-fall breach Clause* (i.e. default in one contract deemed to constitute default in the other) either embedded or provided by way of a separate umbrella agreement encompassing all contracts.

5.1.16 It is important to note that the above discussed categories and indicators of various types of PE are not water-tight compartmentalized definitions, and a PE can be more than of one kind simultaneously. For instance, a project PE can also be a service PE or a fixed-place PE can at the same time be a project PE. Thus all the above features can be used as indicative of whether a foreign company has a PE in India. The focus is not characterization of a PE as a particular type of PE but determination of PE in India by identification of the nature and significance of activities being carried out by the foreign company in India, the roles and responsibilities, and the functions discharged in India and the risks and obligations being assumed by the foreign company in India. Once the same is established, the *next stage is attributing profits* of the non-resident assessee to the said PE, as only profits attributable to the PE would constitute the business income of the non-resident assessee which is chargeable to tax in India. In effect, the determination of a PE is a fact finding exercise.

5.1.17 Attribution of Profits

5.1.17.1 Once for a non-resident assessee, a PE has been determined in India as per Article 5 of the DTAA, the issue, of the extent to which the business profits should be taxed comes into picture. As per *Article 7(1),* only so much of the profits of the non-resident assessee should be taxed in India as is attributable to the assessee's PE in India. (This paragraph is common to most treaties. The UN Model Convention and some treaties e.g. the India-USA DTAA, contain two additional kinds of profits of a non-resident foreign enterprise that can be taxed in India– profits attributable to sales in India of goods and merchandise of the same or similar kind as those sold through the permanent establishment, or profits attributable to other business activities carried on in India of the same or similar kind as those effected through the permanent establishment.)

5.1.17.2 Again, it is important to note that profit attribution has to be done in both states i.e. state of residence and source state. This is provided for by Article 7(2) which states that *'Where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each contracting state be attributed to that permanent establishment profits which it might be expected to make…'*

Thus only when the profit attributable to a PE is acceptable in both countries can the issue, be held to be concluded. If there is a difference in the profits attributed by the source country to the PE and the profit held to be attributable by the country of residence, the same can be resolved either through regular appellate channels or by referring the matter to MAP authorities.

5.1.17.3 Article 7(2) further specifies that the profits attributed to the PE would be such that it would be expected to make, if it was an enterprise distinct and independent from its global enterprise or non-resident assessee(GE), and engaged in activities similar to the GE. Moreover, the dealings between the PE and GE would be treated as dealings that are between independent entities. Thus in effect, the principle of transactions between associated enterprises are to beat arm's length price is brought into play for determining profits of PE.

To elaborate, Article 7(2) mentions that those profits should be attributed to the permanent establishment which:

i. it *might be expected* to make
ii. if it were a *distinct and separate* enterprise
iii. engaged in the *same or similar* activities
iv. under the *same or similar conditions*
v. and *dealing wholly independently* with the enterprise of which it is a permanent establishment.

Thus though the PE is legally not a separate entity, distinct from GE for the purpose of attributing profits to it, it has to be deemed as such. Further, the DTAA mentions, that a PE not only has to be taken as separate entity, it has to deal with the enterprise of which it is a PE, in an independent manner. Thus, the arm's length principle for transactions between Associated enterprises which is separately embodied in *Article 9* of the DTAA in case of separate legal entities, is implied in case of a GE-PE situation on account of the phrase 'dealing wholly independently with the enterprise of which it is a permanent establishment' as mentioned in Article 7(2) of the DTAA.

5.1.17.4 Article 7(3) is a qualifier to the ALP requirement and it modifies ALP by dealing with the allowability of certain specific expenses separately. It specifies that in determination of the profits of a PE, expenses that are incurred for the purposes of the business of the PE shall be allowed as a deduction. By inclusion of this Clause, the treaty gives the contracting states the power to refer to the domestic legislation i.e. for determining allowable business expenses, the provisions of the Act which deal with computation of business profits must be necessarily referred to. Article 7(3) also refers to other typical expenses that are encountered in dealing with foreign companies. This includes *general and administrative expenditure* whether incurred in India or elsewhere.

5.1.17.5 However, no deduction shall be allowed to PE on account of royalties, fees or similar payments for use of patents and other rights etc., paid to the head office or GE. Except in cases of banks no deduction for interest payment on money lent shall be allowed. (The assessment of foreign banks is discussed separately in Chapter 13, Volume 3 on Banking and Financial Institutions). Similarly, payment by HO to PE under the above heads, will not be considered as receipts in the hands of the PE for calculating the profits of the PE.

5.1.17.6 Article 7(4) of DTAA further provides for a situation, where for a global enterprise or non-resident assessee, it has been customary to apportion to its PE's in India and elsewhere, part of its total profits. Article 7(4) specifies that in such cases, notwithstanding Article 7(2), the attribution of profits to a PE determined as per Article 5, may be continued to be done by way of such apportionment. However, the method of apportionment should be such that it leads to the same result as obtained by attribution in general under Article 7 i.e. the arm's length principle is upheld, expenses are allowed as per Article 7 etc.

In certain treaties e.g. the India-China DTAA, there is no Article like Article 7(4). In such cases profits are to be computed as per Article 7(2) at ALP only. Thus irrespective of whether there is a provision dealing with customary allocation of profits such as Article 7(4) or not, the attribution of profits of the PE is limited by Article 7.

Moreover, in determining profits as per Article 7, especially Article 7(2), when profits cannot be definitely ascertained, Rule 10 of the Income-tax Rules, 1962 ('IT Rules') can be resorted to. In some cases for e.g. the India-USA DTAA, an additional Clause is specified in Article 7(2) which is as below:

> *"…In any case where the correct amounts of profits attributable to a permanent establishment is incapable of determination or the determination thereof presents exceptional difficulties, the profits attributable to the permanent establishment may be estimated on a reasonable basis. The estimate adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article…"*

Thus the treaty gives specific right to estimate the profit on a reasonable basis if correct amount of profit attribution is indeterminable. In such cases profit has to be attributed as per Rule 10 of IT Rules. However, even in the absence of this specific Clause, Article 7(2) mandates that the profit attributed should be such that the

PE is expected to make if it were a distinct and separate entity from its GE engaged in same or similar activities. In case it becomes difficult to compute such profits accurately, Rule 10 may be referred to, to compute profits as per Article 7.

5.1.17.7 In the Delhi High Court decision in the case of *Rolls Royce Singapore Pvt Ltd vs. ADIT* (ITA 1278/2010 and others), the issue of attribution of profits to a PE has been dealt with.

In this case the assessee, a Singapore-based company, was offering receipts on account of maintenance services as part of after sales services to taxation as FTS. However, receipts on account of supply of spares were not offered for taxation in India by the assessee on the grounds that it does not have a PE in India. However, the AO was of the view, that the assessee was discharging the contractual obligation of the supplier of the original equipment, providing maintenance services as well as making supply of spares by the assessee company was incidental to the supply of the original equipment made by another company of the Rolls Royce Group. One of the findings was that another company ANR was assessee's executive agent in India and performing these services under assessee's direction and therefore the assessee company had a PE in India in the form of ANR, profits attributable to which were taxed in India.

As regards profit attribution, in this case, it was seen that the assessee was compensating ANR at a lump sum per annum figure of USD 40,000 (in earlier years this had been fixed at 5% of invoice value). *It was held by the ITAT that this cannot be said to be at ALP, as this sort of fixation of remuneration, is not done between two independent parties in an uncontrolled transaction.* Further a profit of 10% of turnover was treated as profits attributable to PE by the ITAT (as against 25% decided by the AO). On further appeal by the assessee and the Department, the Delhi High Court restored back the issue of whether there was a dependent agent PE in India as per Article 5(9) of the India-Singapore DTAA. However, on the issue whether ANR was already adequately compensated and there was no need for further attribution of profits, even if it is held that the assessee had a PE in India, the High Court held that from the facts *it was clear that the assessee could dictate the terms of payment by altering the same* and reducing it to USD 40,000 per annum, from 5% of invoice value as had been done earlier. This clearly led to the inference that the assessee was in a position to dictate the terms and *in the absence of any Transfer Pricing Analysis* by the Transfer Pricing Officer in the instant case, *it cannot be said that such commission could fit the description of "reasonable profits" within the meaning of Article 7(2) of the DTAA.* The High Court upheld the finding of the Tribunal in fixing 10% of the invoice value as 'profits accepted to make' for the purpose of taxation considering the above facts as well as the limited risks assumed by ANR.

5.1.18 Section 44C *vs.* Section 37

5.1.18.1 Section 44C of the Act provides specifically for a limit on the allowance of head office expenditure('HOE) as a deduction in the case of non-residents. Such expenditure to the maximum of five Per cent of adjusted total income is allowable as a business deduction in computing profit of a non-resident taxable in India. The manner of computing adjusted total income is provided in Explanation to Section 44C. It is pertinent to note that at times non-resident taxpayers will claim a deduction for the entire head office expenditure, incurred outside India, claiming that the same is related to earning taxable business income in India. However, Section 44C limits such a claim.

5.1.18.2 The purpose of allowing this deduction of head office expenditure is giving the benefit of the expenses incurred outside India by a non-resident, for earning income in India. However, to ensure that such a claim is reasonable and not disproportionately inflated, a cap on the same is provided by way of Section

44C. An illustrative list of expenses that can be classified as 'head office expenditure' is given in Explanation to Section 44C.

5.1.18.3 The intention of introduction of Section 44C of the Act is to provide a fair method of allocation of HOE. In the absence of provisions of Section 44C, the HOE cannot be allowed at all. The HOE is in the nature of general administrative expenses, which are allocated costs and hence the allowance of such expenses as deduction shall always be subject to restrictions of domestic law under Section 44C.

5.1.18.4 In some cases it is seen that over and above claim of head office expenditure under Section 44C, assessee's also claim deduction of similar expenditure under Section 37. In view of the specific deduction under Section 44C available for head office expenditure, it needs to be examined whether the assessee is eligible for an additional claim under Section 37 of the Act.

5.1.18.5 Assessee's often claim a deduction under Section 37 from their business profits taxable in India, for certain expenditure incurred outside India by the head office arguing that such payments are not covered in head office expenditure as specified in Section 44C and the same is not subject to the threshold limit provided in Section 44C. Therefore, the assessee's claim that such expenditure are separately allowable under Section 37.

5.1.18.6 In this regard firstly, the claim of the assessee that this expenditure is not in the nature of executive and general administrative expenditure incurred outside India by the head office and not covered by Section 44C needs to be examined. The assessees in some cases rely on Explanation (iv) to Section 44C to state that such expenditure is not covered under Section 44C of the Act. However, as already discussed, the definition in Explanation (iv) is an inclusive definition and the list provided therein regarding the types of expenditure which will be treated as executive and general administrative expenditure is not exhaustive. Therefore, the assessee cannot state that an expense is not covered under the definition of executive and general administrative expenditure as per Section 44C, as the list therein is only illustrative and expenditure not listed therein can also be considered as being in the nature of executive and general administrative expenditure. When the the head office has incurred the expenditure outside India and the expenditure is of a general administrative nature, claim w.r.t. the same if any is subject to the limitation in Section 44C.

5.1.18.7 Alternatively it can also be argued that such expenditure is not of a nature laid out or expended wholly and exclusively for the purposes of business or profession and therefore is not allowable under Section 37. Only when the PE is the principle beneficiary of a service, will claim of expenditure w.r.t. the same be classifiable under Section 37 of the Act.

5.1.18.8 In the case of *Dhimant H. Thakkar vs. CIT* B.C.-II (Income-tax Reference No. 487 of 1997; date of order 28 October, 2015), Hon'ble Bombay High Court had occasion to consider the expression "wholly and exclusively" as used in Section 37(1) of the Act. Reference to the decisions Hon'ble Supreme Court in the case of *Sasoon J. David & Co. Pvt. Ltd vs. Commissioner of Income-tax* (Bombay) (118 ITR 281), *Eastern Investments Ltd vs. Commissioner of Income-tax* West Bengal 20 ITR and an unreported decision of *Hon'ble Bombay High Court in Commissioner of Income-tax vs. NGL Network (I) Pvt. Ltd.* (Income-tax Appeal No. 538 of 2012) was made before the Hon'ble Court. Hon'ble High Court have mentioned the following in this regard:

> *"However, in all the above cases, persons other than the assessee who incurred the expenditure also benefited. In the above context, it was held that where such expenditure is incurred for the purposes of the business and some third party gets incidental benefit, the expenditure under Section 37(1) of the Act cannot be disallowed."*

Hon'ble High Court then laid down the principle that, if it is found that it is the assessee who is getting incidental benefit, then it cannot be said that the expenditure was wholly or exclusively for the purposes of its business (para 15 of the order). This principle also emerges from the decisions of Hon'ble Supreme Court mentioned above, where benefit was arising to other parties also, but the benefit to parties other than the assessee was incidental in nature, and not otherwise.

5.1.18.9 Thus when benefit if any arising to the India operations is only incidental, then expenditure made for availing such services cannot be said to be wholly and exclusively for the purpose of business within the meaning of Section 37 of the Act. Therefore expenditure which is incurred by the head office outside India is not an allowable deduction under Section 37.

5.1.18.10 Moreover, Section 37 also mandates that the expenditure claimed by the assessee for the purposes of computing its income from business, has to be laid out, or expended wholly and exclusively. Thus even the condition of expenditure being laid out is not satisfied in this case as the expenses are neither incurred, nor debited in the books of accounts of its Indian operations.

5.1.18.11 In this regard, it is important to note that Section 44C starts with a non-obstinate Clause, *'Notwithstanding anything to the contrary contained in Sections 28 to 43A…'*. Therefore Section 44C has been specifically brought in to limit the benefit of claim of head office expenditure granted to non-residents and an expenditure that is allowable under the same is subject to the threshold limit provided therein. Head office expenditure cannot be claimed under Section 37 of the Act, over and above the threshold limit specified in Section 44C of the Act.

5.1.19 PE Timing—Satisfaction of Time Threshold and Taxation of Receipts after a PE Ceases to Exist

5.1.19.1 A key issue, that comes up for consideration while examining if the duration test is satisfied in cases of PE, is whether the time-threshold to be satisfied e.g. 6 months for a Project PE, has to be satisfied for each Assessment Year separately. In other words, for ascertaining whether Project PE existed in a particular Assessment Year whether it should be in existence for a period exceeding 6 months in that year or once the PE is in existence for more than 6 months (irrespective of whether it happens exclusively in one year or across multiple Assessment Years) then the duration test remains satisfied till PE is in existence.

5.1.19.2 The concept of a permanent establishment has a long history. The temporal aspects of the existence of a PE vis-à-vis its existence in a calendar or assessment year, and taxation of income received after the closure or liquidation of the PE are more or less well settled in international tax law.

5.1.19.3 Reference is made to the following in this regard:

i. Dr. Klaus Vogel, in his seminal work 'Klaus Vogel on Double Taxation Conventions' (3rd edition) has stated at M.No. 76 on Article 5 of the OECD MC that, "According to OECD MC and US MC, the minimum length of time a building site or construction or installation project must last in order to constitute a permanent establishment is 12 months. If it lasts for more than 12 months, the permanent establishment, rather than beginning to exist at that point of time, is deemed to have existed from the very outset. … *It makes no difference to the time test whether the activities in question extend over more than one calendar year or one assessment period. If part of the period were to be in one year, and the remainder in the next, this would not prevent a permanent establishment from coming into existence."* (emphasis added)

ii. From the above, it is clear that the DTAA does not require the time test to be fulfilled in each and every assessment year–once the PE comes into existence after fulfilling the condition of existence for more than six months under Article 5(2)(i), it will continue to exist in all the assessment years where its existence overlaps, up to the date of completion of its contract. Thus, if a six-month test is provided in any DTAA entered into by India, then it does not matter that the PE exists in a particular assessment year for less than six months. The duration test is applied to the PE as a whole and if the PE per se fulfils the conditions, then it will be regarded as continuing to exist even in the assessment year in which its existence was for less than six months.

5.1.19.4 With regard to taxation of amounts received after the permanent establishment has ceased to exist as well, international tax law appears to be well settled.

i. Dr. Klaus Vogel has mentioned in the same work at M.No.6 pertaining to 'Preface to Articles 6 to 22' that, "In connection with the application of distributive rules, particular problems are apt to arise whenever items of income are received during a period other than the one in which they accrued *(advance income, subsequent income)***.** Rather than looking at whether or not the requirements of the distributive rule had already been, or were still being satisfied at the time when the items of income were received, the decisive point is to determine the time when the income was 'earned', *viz.* when whatever *decisively caused* the income to accrue, actually occurred."

ii. Dr. Vogel has further elaborated the above at M.No. 34 pertaining to Article 7 of OECD MC by stating that, "The permanent establishment must have existed at the time when whatever *decisively caused* the profits to accrue, actually occurred. If this is so, the State of the permanent establishment is entitled to impose tax, even if the profits did not accrue until after the permanent establishment had been liquidated …".

Thus, if the receipts have accrued and arisen on account of activities undertaken by the PE when it was in existence, then the receipts are taxable even after the PE has ceased to exist.

5.1.19.5 In some cases, where specific treaty provides for it, 'force of attraction' rule can be invoked to tax receipts related to a PE even when PE does not exist in that year. In other words, if separate PEs exist during any assessment year, the revenues can be considered for taxation even if the time test in case of some projects is not fulfilled. However, in general, unless the DTAA specifically allows to do so (for example, the India-USA DTAA, Article 7(1)) such limited 'force of attraction' principle cannot be applied to PEs. This is because in treaty law, each PE is to be considered as a separate PE (reference, Klaus Vogel, ibid; Article 5, M. No. 79: *The question whether there is a permanent establishment in a specific contracting State or not should be considered separately for each business activity performed in that State, i.e. for each individual place of business existing there as well.*"

5.1.19.6 However, irrespective of whether force of attraction rule is embedded in a treaty or not, the main issue in all cases where income is received after a PE ceases to exist, is that income is brought to tax in a particular tax period on the basis of the Domestic Law (in the case of India, the Income-tax Act, 1961) and the DTAA is for providing relief. The DTAA does not and cannot subject any receipt to charge of tax if it cannot be done so under the domestic law. Thus, in the present case, the DTAA could not have provided for the taxation of receipts of a PE in any particular assessment year. That has to be done on the basis of the domestic law, and the DTAA only resorted to for providing relief.

5.1.19.7 Dr. Klaus Vogel has mentioned in this regard (ibid; Introduction, M. No. 26) that:

> "States levy taxes, however, only on the basis of their own tax laws. … **Tax treaty rules** assume that both contracting States tax according to their own law; unlike the rules of private international law, therefore, treaty rules do not lead to the application of foreign law. Rather, treaty rules, to secure the avoidance of double taxation, **limit** the **content** of the tax law of both contracting States; in other words, the legal consequences derived from them **alter** domestic law, *either by excluding application of provisions of domestic tax law where it otherwise would apply, or by obliging one or both States to allow a credit against their domestic tax law for taxes paid in the other State.* Within the scope of a treaty, therefore, a tax obligation exists only if and to the extent that, in addition to the requirements of domestic law, the treaty requirements also are satisfied.

Again (ibid; Introduction, M. No. 45b) he mentions that

> "Further, treaty rules neither authorize, nor 'allocate' jurisdiction to tax to the contracting States."

He again emphasizes that (ibid; Introduction, M. No. 46):

> *"In contrast, a tax treaty neither generates a tax claim that does not otherwise exist under domestic law nor expands the scope or alter the type of an existing claim …"*

5.1.19.8 Thus, the taxation of the receipts of a PE which were received after its closure have to first be taxable under a specific provision of the Income-tax Act, 1961 and then only the question will arise as to whether the receipts are still taxable under the DTAA also.

5.1.19.9 The building, construction, installation or supervisory permanent establishment is in the nature of a business entity in India, deemed to come into existence under the force of a specific Article of the DTAA. Under Article 7 of the DTAA, it has to be treated as a separate enterprise for attribution of profits. Once the PE ceases to exist, the business entity, which was deemed into existence in India, also ceases to operate for the purpose of taxation of business profits. Thus, the receipts of this discontinued or closed enterprise should be taxable under a specific provision of the Income-tax Act, 1961 and then it should be seen whether the treaty restricts its taxation or not.

5.1.19.10 The Income-tax Act, 1961 contains specific provisions with regard to 'discontinuance of business, or dissolution'. These are contained in Chapter-XV (L) of the Act. Section 176(3A) of the Act mentions the following in this regard:

> *"Where any business is discontinued in any year, any sum received after the discontinuance shall be deemed to be the income of the recipient and charged to tax accordingly in the year of receipt, if such sum would have been included in the total income of the person who carried on the business had such sum been received before such discontinuance."*

5.1.19.11 Thus, the discontinuance of a PE is to be construed as the discontinuance of a business in India and the sum received by the assessee after discontinuance of its PE in India but which pertain to the activities of the PE in India during its existence are to be taxed as income of the assessee in India arising to its PE in the assessment year in which they were received.

5.1.19.12 It also needs to be kept in mind that the treaty practice in this regard has evolved in a particular manner much to the insistence on this in the treaties signed by the USA. Thus, Clause III to the Protocol to the India-USA DTAA mentions the following:

> "AD ARTICLES 7, 10, 11, 12, 15 and 23- *It is understood that for the implementation of paragraphs 1 and 2 of Article 7 (Business Profits) …, any income attributable to a permanent establishment or fixed base during*

its existence is taxable in the Contracting State in which such permanent establishment or fixed base is situated even if the payments are deferred until such permanent establishment or fixed base has ceased to exist."

5.1.19.13 This Clause in the Protocol is repeated in all the treaties entered into by the USA. Thus, the USA has clearly insisted on expressing in words what has remained unspoken but implied in principle in other treaties. However, for the issue at hand, the significance of citing the protocol lies in the explanation provided for this in the 'Technical Explanation of the Convention and Protocol' issued by the US Treasury with regard to the India-USA DTC. This Technical Explanation mentions under Article 7 the following:

"This Protocol paragraph incorporates the principle of Code Section 864(c)(6) into the Convention. Like the Code Section on which it is based, Paragraph III of the protocol provides that any income or gain attributable to a permanent establishment (or, in the context of Articles 10, 11, 12, 15, and 23, a fixed base as well) during its existence is taxable in the Contracting State where the permanent establishment (or fixed base) is situated even if the payments are deferred until after the permanent establishment (or fixed base) no longer exists."

5.1.19.14 Thus, it is clearly mentioned in the Technical Explanation (which is meant for the US IRS) that the protocol simply follows the principle put in place in the IRS Code Section 864(c)(6), i.e. the US domestic tax law. Thus the receipts are taxed as per the US domestic legislation and only once a receipt comes within the ambit of tax as per the US domestic taxation law, will the issue of application of treaty arise. It would be pertinent here to look into the provisions of the particular Section in the US Code referred to in the Technical Explanation specified above:

"(6) Treatment of certain deferred payments, etc.

For purposes of this title, in the case of any income or gain of a non resident alien individual or a foreign corporation which—

A. *Is taken into account for any taxable year, but*

B. *Is attributable to a sale or exchange of property or the performance of services (or any other transaction) in any other taxable year,*

the determination of whether such income or gain is taxable under Section 871(b) or 882 (as the case may be) shall be made as if such income or gain were taken into account in such other taxable year and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the taxable year referred to in subparagraph (A)."

5.1.19.15 It is evident from the above, that it is based on this specific provision of the domestic law the treaties entered into by USA have their specific Clause III in their Protocol. Similarly, only once a receipt is taxable as per the Indian Income-tax Act, will the issue of taxing the same come into the picture. It is the cardinal principle of treaty law, that a receipt that is not taxable as per the domestic tax law, will not be taxed by way of treaty. The above provision taxing income received after a business has ceased to exist in the domestic tax law of USA is similar in nature to the provisions contained in Section 176(3A) of the Income-tax Act, 1961–the Indian domestic tax law.

5.1.19.16 Accordingly, first Section 176(3A) of the Act is required to be invoked to tax the receipts of a PE after its closure in the previous year of receipt. The DTAAs do not limit such taxation–as has been shown in treaty practice and law.

5.2 Taxation of Receipts as Royalty

5.2.1 As per Section 9(1)(vi) receipts in the nature of royalty in the hands of a person are deemed to accrue and arise in India if the same

is payable by the Government, resident (unless it is for businesses outside India), a non-resident for businesses in India. Thus royalty receipts in the hands of non-residents are taxable in India as per Section 9(1)(vi) subject to some conditions. Further Explanation 2 to Explanation 6 of this Section also provides definitions and clarifications related to the definition of royalty.

5.2.2 Correspondingly *Article 13* of DTAA (for reference India-UK DTAA) modifies this taxation right. Article 13(1) holds that royalty would be taxable in the resident country. Article 13(2) however, gives the right of taxation to the source country (in our case India) as well with some relief from taxation under domestic legislation by way of beneficial rate of taxation subject to certain conditions.

5.2.3 The issue of taxation of software under the head royalty is the most litigated issue in taxation of royalty. The issue whether income from use of software could be characterized as royalty has been considered by various High Courts and Tribunals. Karnataka High Court has held that it is royalty, while Delhi HC has held that it is not royalty. At present the matter is pending before the Hon'ble Supreme Court of India.

5.3 Taxation of Receipts as Fees for Technical Services (FTS)

5.3.1 As per Section 9(1)(vii) receipts in the nature of Fee for Technical Services ('FTS') in the hands of a person, are deemed to accrue and arise in India if the same is payable by the Government, resident (unless it is for businesses outside India), a non-resident for businesses in India. Explanation 2 to Section 9(1)(vii) defines FTS to mean consideration for rendering of managerial, technical or consultancy services. It however specifically excludes such consideration when received for any construction, assembly, mining or similar project, if such receipts are taxable in the hands of the recipient under the head 'Salaries'.

5.3.2 The DTAA deals with FTS separately under Article 13 (India-UK DTAA used for reference). Most DTAAs also specify FTS to include managerial, technical or consultancy services.

5.3.3 The terms managerial, technical or consultancy services are not specifically defined in the Act and have a broad meaning. It is also important to note that assesses often argue that a service is either only managerial, or only technical or only consultancy. This especially happens in cases where the treaties might omit one of these terms, for e.g. the current amended India-UK DTAA only specifies FTS to mean technical or consultancy services and the term 'managerial' is not mentioned therein. The India-UK DTAA defines FTS as below:

> *"4. For the purposes of paragraph 2 of this Article, and subject to paragraph 5, of this Article, the term "fees for technical services" means payments of any kind of any person in consideration for the rendering of any technical or consultancy services (including the provision of services of a technical or other personnel) which:*
>
> a. *Are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment described in paragraph 3(a) of this Article is received, or*
>
> b. *Are ancillary and subsidiary to the enjoyment of the property for which a payment described in paragraph 3(b) of this Article is received, or*
>
> c. *Make available technical knowledge, experience, skill, know-how or processes or consist of the development and transfer of a technical plan or technical design.*
>
> *5. The definition of fees for technical services in paragraph 4 of this Article shall not include amount paid:*
>
> a. For services that are ancillary and subsidiary, as well as inextricably and

essentially linked, to the sale of property, other than property described in paragraph 3(a) of this Article;

b. For services that are ancillary and subsidiary to the rental of ships, aircraft, containers or other equipment used in connection with the operation of ships, or aircraft in international craft;

c. For teaching in or by educational institutions;

d. For services for the private use of the individual or individuals making the payment;

e. To an employee of the person making the payments or to any individual or partnership for professional services as defined in Article 15 (Independent personal services) of this Convention."

In such cases, the assesses may argue that the services rendered by them are 'managerial' services and as managerial services are not mentioned in Article 13 dealing with FTS in the DTAA, receipts on account of rendering of such services are not taxable in India.

5.3.4 It is important to understand that there is lot of overlap amongst technical, managerial and consultancy services, and a service can at the same time be a managerial service, a technical service and a consultancy service or any other combination. Hence, one cannot say that since services are in the nature of managerial services and the term 'managerial' is not used in India UK DTAA, the services rendered are not covered in the definition given in the DTAA. This is because due to overlapping nature, the same services, which are thought to be of managerial nature, could also be technical or consultancy services- the two terms which are used to defined FTS in India-UK DTAA.

5.3.5 Thus it is important to understand the specific nature of services being rendered by the assessee to determine whether the receipts in lieu of the same qualify as FTS taxable under the Act and the treaty. Besides the examination of primary documents such as agreements and invoices, nature of services should also be ascertained by examining the general processes and procedures used in rendering such services, examining service agreements, documented communications, skill level of personnel rendering the service, general expertise of the assessee in rendering such services, technical experience etc. Nature of services, manner of rendering them and other sector-specific examination of details would ascertain whether a particular service is classifiable as FTS (depending on whether the same is managerial, technical or consultancy service or a combination of them). Some judgements are discussed below for illustration. However, the same are merely illustrative and not exhaustive.

5.3.6 While advice of routine nature may not fall under the category of technical or consultancy services, the AAR in the case of *Shell India Marketing Private Limited* (AAR) 2012-LL-0117-28 has held that advice that require specialized technical knowledge, special knowledge of the applicant's business and industry, will qualify as technical or consultancy services. Thus General Business Support Services were held as consultancy services. It was also held by the AAR in Shell India that, some of the services being rendered under the General Business Support Services Agreement may not be technical in nature, but all the services (technical and non-technical services) come as a bundle and cannot be segregated, and therefore all receipts under the agreement would qualify as FTS.

5.3.7 *GVK Industries* (SC) 54 taxmann. com 347: In this case, the assessee company constructed and erected power-generating station designed to operate using industrial gas as fuel near Rajamundri. The assessee company intended to utilize the expert service of *qualified and experienced professional* who would prepare a scheme for raising the finances and tie up the required loan. A non-resident company offered its services as a financial advisor to the

company's project. The services offered by the non-resident company included *financial structure and security package to be offered to the lender, study of various lending alternatives* for the local and foreign borrowings, making an assessment of export credit agencies world-wide and obtaining commercial bank support on the most competitive terms, assisting the petitioner-company in loan negotiations and documentation with lenders and structuring, negotiating and closing the financing for the project in a co-ordinated and expeditious manner. For its services the assessee company paid 0.75% of the total debt financing as "success fee". On the advice of the non-resident company at Zurich, the assessee approached the Indian finance institution for loan. The assessee also approached the International Finance Corporation, USA for a part of its foreign currency loan requirement. After successful rendering of service, the non-resident Zurich company sent an invoice for payment of "success fee" to the extent of US$ 17,15,476.16 (Rs. 5.4 crores). The assessee company approached the Income-tax authorities in India for issuing a no objection certificate to remit the said amount, claiming that the non-resident company had no permanent establishment in India, and all services were rendered from outside India. The Income-tax Officer refused to issue the certificate. On a writ petition before the High Court it was held that the scope of service/ work undertaken by the non-resident company was merely to draw up a scheme, advise on the terms and methods of negotiation and for documentation with the lender, evaluate the pros and cons of various lending alternatives, both for local and the foreign borrowings, prepare a preliminary information memorandum to be used as the basis for placing the foreign and local debt, and that the responsibility of entering into correspondence as per the advice of the non-resident company and pursuing the matter was that of the assessee company itself, and not that of the non-resident company. Therefore, the office of the assessee company could not be treated as the place of business of the non-resident company. In those facts and circumstances, the Andhra Pradesh High Court found that the business connection between the assessee Company and non-resident company had not been established. However, it was found that the "success fee" would fall within the definition of 9(1)(vii)(b) of the Act. *The Andhra Pradesh High Court found that advice given to procure loan to strengthen finances would be as much a technical or consultancy service, as it would be with regard to management, generation of power or plant and machinery.* The "success fee" was chargeable under the provisions of the Income-tax Act, and therefore, the assessee was not entitled to no objection certificate.

The Apex court upheld the judgment of the High Court explaining the 'source rule' and the definition of 'consultancy'. It held that:

> *"As the factual matrix in the case at hand, would exposit the NRC had acted as a consultant. It had the skill, acumen and knowledge in the specialized field i.e. preparation of a scheme for required finances and to tie-up required loans. The nature of activities undertaken by the NRC has earlier been referred to by us. The nature of service referred by the NRC, can be said with certainty would come within the ambit and sweep of the term 'consultancy service' and, therefore, it has been rightly held that the tax at source should have been deducted as the amount paid as fee could be taxable under the head 'fee for technical service'. Once the tax is payable/ paid the grant of 'No Objection Certificate' was not legally permissible. Ergo, the judgment and order passed by the High Court are absolutely impregnable."*

5.3.8 In the case of *Continental Construction* (SC) 195 ITR 81, the Hon'ble Supreme Court held that where a person consults a lawyer and seeks an opinion from him on some issue, the advice provided by the lawyer will be a piece of technical service provided by him. Thus

"Technical Services" include "Professional Services".

5.3.9 As per Article 13(4)(a) of the Treaty, payment for *services ancillary or subsidiary to the enjoyment of a right* that is taxable as *royalty,* will classify as FTS chargeable to tax under the Treaty. Thus if an assessee is already offering a receipt for taxation as royalty, or a receipt has been held to be chargeable as royalty during the course of assessment, then a receipt for services that are ancillary or subsidiary to the same would be taxable as FTS.

5.3.10 However, most disputes regarding the taxability of a particular receipt as FTS arise due to the restrictive definition of FTS in most DTAA as against the Act. This arises because many DTAA's have the additional restrictive requirement of a condition called ***'make available'*** as specified in Article 13(4)(c) being satisfied in cases of services where the receipt,if to be taxed as FTS, must make available technical knowledge, skills etc.

5.3.11 FTS as per Article 13(4) of the DTAA, must *'make available' technical knowledge, experience, skill, know-how or processes or consist of the development and transfer of a technical plan or technical design.*

5.3.12 Many Courts have interpreted that technical knowledge, experience, skill etc. *are made available when* the receiver of such services is enabled to apply them independent of the service provider i.e. without the aid of the service provider or after the service provider has ceased to render such services to the receiver. Some instances of such services are when training is provided or when plans or designs are shared. But in most of such cases the receipts are usually offered as FTS and there is no dispute between the taxpayer and the Department.

5.3.13 However, the above interpretation of the term 'make available' is generally considered by the Revenue as an interpretation that is more restrictive than intended. The Revenue and several judicial authorities have held that the term 'make available' should be interpreted as providing of a benefit that is of an enduring nature to the service receiver.

5.4 Place of Effective Management (POEM)

5.4.1 Place of Management vs. Place of Effective Management in the Context of a DTAA: Article 4(1) of many of our DTAAs mention 'place of management' as one of the criteria used for determining residence (apart from domicile, residence etc.). This criterion is internationally understood to be interpreted through domestic law. On the other hand, Article 4(3) of the DTAAs would generally mention the term 'place of effective management', which in contradistinction, is a treaty term, and is to be used as a 'tie-breaker'. It is generally understood to have the meaning as the place where the top-level management sits—a place where the important policies are actually made (and not simply where they take effect).

5.4.2 POEM as a Tie-breaker Test: The tie-breaker test comes into operation only when as per the domestic law of the two Contracting States, a person is considered to be resident in both of them. If we take the case of a company which is incorporated in a particular Contracting State and is resident therein, the tie-breaker test can only apply if that company is somehow considered as resident in India as per the IT Act.

Prior to it amendment in 2016, Section 6(3) provided the following test of residence in India in case of companies: (a) an Indian company is resident in India, and (b) any other company the 'control and management' of whose affairs is wholly situated in India, is also resident in India. Sub-Section 3 of Section 6, prior to its substitution by the Finance Act, 2016, the same read as below:

> *(3) A company is said to be a resident in India in any previous year, if:*
>
> i. it is an Indian company; or.
>
> ii. during that year, the control and management of its affairs is situated wholly in India.

Thus, for a foreign company to be resident in India, this second test was required to be fulfilled. If this was satisfied, then, and only then, the tie-breaker rule in Article 4(3) of the tax treaty would be attracted.

5.4.4 Control and Management Situated Wholly in India: It is evident in case of companies other than Indian companies, the concept used in the earlier version of Section 6(3) was that of 'control and management' and not simply 'place of management'. This concept had its origins in common law. It was not there originally in the Act of 1922. It was introduced by the Indian Income-tax (Amendment) Act, 1939 in the form of Section 4A. Its meaning was derived from the House of Lords decision in the case of *De Beers vs. Howe* (1906) which used the term and *central management control* and which came to be recognised in common law as the CMC test (Central Management and Control test). This test simply determines the place from which the real business is carried on. Thus, the word 'wholly' as appearing in Section 6(3) in the context of 'control and management' *gets converted into* a test for Central Management and Control. This principle as laid down in De Veers *vs.* Howe was accepted by Hon'ble Supreme Court of India in the case of an HUF in the case of *V.V.R.N.M. Subbayya Chettiar vs. Commissioner of Income-tax,* Madras ((1950) S.C.R. 961, 965). However, later decisions went for a literal and stricter interpretation and the common law test of 'central management and control' was relegated to the background. The result was that even one or two board meetings outside India were sufficient to fail the test of 'wholly' as used in Section 6(3). It is in this backdrop, that the for Amendment to Section 6(3) was carried out in 2016.

5.4.5 Section 6(3) as substituted by the Finance Act, 2016 w.e.f. 01/04/2017 now reads as under:

(3) A company is said to be a resident in India in any previous year, if:

i. It is an Indian company; or

ii. Its place of effective management, in that year, is in India.

Explanation—For the purposes of this Clause "place of effective management" means a place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole area, in substance made.

5.4.6 Concept of POEM in the Act: Thus the Amendment in 2016 has brought in the treaty, the term 'place of effective management' into domestic law. It has one important advantage. India's DTAAs do not contain the definition of the term 'Place of effective management'. Thus, in terms of Article 3(2) of our DTAAs, if any term is left undefined, then its domestic law meaning is to be taken, unless the context otherwise requires. Hence, in case of foreign companies, the same definition will act as a test of residence in domestic law, and also, once residence is found to be in India, as the definition of POEM, as a tie-breaker rule. The Act now defines POEM to mean a place where key management and commercial decisions for the entity as a whole are in substance taken. Thus, it brings the doctrine of 'substance over form' into play in an explicit manner.

5.4.7 Thus the criteria for determining whether a foreign company is a resident company has been changed w.e.f. 01/04/2017 (AY 2017–18 and subsequent assessment years) by the above amendment by holding that its place of effective management or POEM in that year is in India. This has an important ramification on taxation in case of foreign companies because if a foreign company is held to be a resident company it will be taxable on its global income as per Section 5(1) of the Act, instead of only part of the income as per Section 5(2) of the Act when it is a non-resident.

5.4.8 CBDT has issued Circular No. 6 of 2017 dated 24/01/2017 on the subject of *Guiding Principles for Determination of Place of Effective*

Management (POEM) of a Company. The main contours of the Circular are as follows:

i. It introduces the concept of 'passive income' (para 5(c) of the Circular) to mean aggregate of (a) income from transactions where both purchase and sale of goods is from/ to related parties; (b) income from royalty, capital gains, rentals, dividend and interest (not included when the entity is in banking business)

ii. Then it utilizes this concept for defining a company engaged in 'active business outside India' as a company in the case of which not more than 50% of the total income is constituted of 'passive income' and, less than 50% of the assets are situated in India, and less than 50% of the employees are employed in India or are resident in India, and the payroll expenses on such employees is less than 50% of total payroll expenses (cumulative conditions)

iii. Then, para 7 of the Circular mentions that in case of companies which are engaged in 'active business outside India', POEM shall be presumed to lie outside India if the majority of board meetings are held outside India.

However, as the statute clearly provides that substance is required to be looked into and not form (that is, number of meetings held outside India), para 7.1 of the Circular then brings back *De Beers vs. Howe* (supra) by stating that if facts and circumstances show that the Board of Directors (BOD) is standing aside and letting the parent or other group entity to take major decisions in India, then POEM will be considered to be in India.

5.4.9 In case of companies which are not engaged in 'active business outside India', the Circular proposes a two-step process for determination of POEM:

i. Identifying the persons who take key management and commercial decisions for the company as a whole, and

ii. Determining the place where such decisions are actually being made.

The basic idea is that the place where such decisions are actually made is more important than where they are implemented. Further, in such matters, again it is the substance which has to be looked into, and not the form. The Circular also provides, by way of example, certain instances of determining POEM (Para 8.2 of the Circular).

5.4.10 Paragraph 8.2(c) mentions that for determination of POEM, the location of the head office is of great importance. In cases where the company has a decentralized structure (or regionalized structure), this determination is even more crucial. Where various senior management personnel are operating, the head office is the place where they return to from foreign visits, and the place where the meet to finally take decision on matters. Where key management personnel are based in many locations and interact through, in general, video conferencing etc., the head office is the place where the highest level of management is located (MD, CFO etc.). However, it is recognized that in many cases, even these methods may not be sufficient. Place where substantial or main activity is carried out or where the accounting records are kept can also be important.

5.4.11 In the end, the Circular points out that these are indicative only. As Section 6(3) of the Act embodies the 'substance over form' doctrine after amendment, any determination of the POEM will depend upon the facts and circumstances of a given case. The Circular also specifies that since "Residence" is to be determined for each year, POEM will also be required to be determined on year to year basis. Paragraph 11 of the Circular also provides for a high-level approval structure for determination of POEM.

6. SOME IMPORTANT JUDICIAL DECISIONS

6.1 Formula One World Championship Limited

6.1.1 The case of *Formula One World Championship Limited* [2017] TS-161-SC-2017 is a landmark judgement regarding the satisfaction of *duration test in the case of a* PE. It was held in the same, that short duration activities can constitute a PE depending upon the recurrence of the activities and nature of business of the assessee.

6.1.2 Facts of the Case

6.1.2.1 The assesse, Formula One World Championship Ltd ('FOWC') is a tax resident of UK.

6.1.2.2 Consequent to agreements entered into between the Federation International Automobile ('FIA' an international motor sports events regulating association), Formula One Asset Management Limited (FOAM) and FOWC, FOAM licensed all commercial rights in the FIA Formula One World Championship (Championship) to the assessee FOWC for 100-year term effective from 01/01/2011.

6.1.2.3 The assessee entered into a Race Promotion Contract (RPC) by which it granted to Jaypee Sports the right to host, stage and promote Formula One (F1) Grand Prix of India event for a consideration of USD 40 million. An Artworks license Agreement contemplated in RPC was also entered into between assessee and Jaypee the same day permitting the use of certain marks and intellectual property belonging to assessee for a consideration of USD 1 million.

6.1.2.4 The assessee and Jaypee both approached the AAR and sought advance ruling on the following questions:

1. Whether the payment of consideration receivable by FOWC (assessee) in terms of the said RPC from Jaypee was or was not royalty as defined in Article 13 of Indo-UK DTAA?
2. Whether FOWC(assessee)was having any permanent establishment (PE) in India in terms of Article 5 of the DTAA?
3. Whether any part of the consideration received or receivable by FOWC(assessee) from Jaypee outside India was subject to tax at source under Section 195 of the Indian Income-tax Act, 1961?

6.1.3 AAR Ruling

The AAR concluded that firstly the amounts paid were taxable as 'royalty'. Secondly, the AAR held that assessee had no fixed place of business, was not doing any business activity in India and had not authorized any organisation or entity to conclude contracts on their behalf and, therefore, had no PE in India. On the issue of deduction of tax at source under Section 195, the AAR held that as the receipts are held taxable as royalty, corresponding TDS should be deducted by Jaypee on payments made to the assessee.

6.1.4 Decision of the High Court

The assessee and Jaypee appealed against the decision of the AAR in holding the payment as royalty. The Revenue also filed further appeal arguing that the assessee had a PE in India. The Delhi High Court reversed the findings of AAR on both the issues. It held that the amount paid/ payable under RPC by Jaypee to assessee would not be treated as royalty. Further, as per High Court assessee had PE in India and, therefore, the profits attributable to the same were taxable in India. The High Court has also held that Jaypee is bound to make appropriate deductions from the amount payable to assessee under Section 195.

6.1.5 Decision of the Supreme Court

6.1.5.1 Further appeal was filed to the Supreme Court by the assessee and Jaypee, in which they contended that no tax was payable in India on the consideration paid under RPC, as it was neither royalty nor did the assessee had any PE in India.

6.1.5.2 The Supreme Court ruled that F1 event conducted in India was a virtual projection of the taxpayer on the Indian soil. Further, on the basis of findings and legal provisions, SC ruled that the taxpayer had a fixed place of business in the form of physical location, i.e. Circuit, which was at the disposal of the taxpayer through which it conducted business. Therefore the assessee had a PE in India and the profits attributable to the same were taxable in India.

6.1.5.3 Following are the Key Takeaways of the Ruling

a. SC noted that as per Article 5 of the DTAA, the PE has to be a fixed place of business 'through' which business of an enterprise is wholly or partly carried on. SC held that the *international circuit is a fixed place* and since races are conducted from this circuit, it is an *economic/ business activity.*

b. To examine whether international circuit was put at the disposal of assessee and whether it was a fixed place of business of assessee, SC referred to the arrangement between assesse and its affiliates. SC held that *various agreements cannot be looked into by isolating them from each other* and their *wholesome reading was necessary to bring out the real transaction between the parties.* Such an approach is essentially required to find out as to who is having real and dominant control over the Event.

c. SC held that the various arrangements entered into between the taxpayer and its affiliates demonstrated that the entire event i.e. media, title sponsorship and paddock rights were taken over and controlled by the taxpayer and its affiliates. SC stated that even the physical control of the circuit was with taxpayer and its affiliates from the inception, i.e. inclusion of event in a circuit till the conclusion of the event. SC remarked that "Omnipresence of FOWC and its stamp over the event is loud, clear and firm."

d. Regarding the *duration of the event* to determine permanency, it was held that the *activity was in the nature of shifting* and the *access granted to the taxpayer for 2 weeks was sufficient for creating a PE.* SC clarified that "The question of the PE has to be examined keeping in mind that the aforesaid race was to be conducted only for three days in a year and *for the entire period of race the control was with FOWC."*

e. Accordingly, SC concluded that the taxable event had taken place in India and non-resident taxpayer was liable to pay tax in India on the income it has earned on this soil. SC held that since payments made by Jaypee to the taxpayer under the RPC were business income of the taxpayer through PE at the Buddha International Circuit, and, therefore, chargeable to tax, Jaypee was bound to make appropriate deductions from the amounts paid under Section 195 of the Act.

6.1.5.4 The Supreme Court also made the following observations:

a. If a non-resident has a permanent establishment in India, then business connection in India stands established.

b. In Para 30 of its order, relying on the commentary of Philips Baker, the Supreme Court has listed an illustrative list of PE's:

   i. A shed which has been rented for 13 years for storing and preparing hides.

   ii. A writer's study.

   iii. A stand at a trade fair, occupied regularly for three weeks a year, through which the enterprise obtained contracts for a significant part of its annual sales.

   iv. A temporary restaurant operated in a mirror tent at a Dutch flower show for a period of seven months.

v. An office, workshop and storeroom for the maintenance of aircraft

c. The principal test in order to ascertain as to whether an establishment has a fixed place of business or not, is that such physically located premises have to be *'at the disposal'* of the enterprise.

d. It is not necessary that the premises are owned or even rented by the enterprise. It will be sufficient if the premises are put at the disposal of the enterprise.

e. It is clarified that a place of business may also exist where no premises are available or required for carrying on the business of the enterprise and its imply has a certain amount of space at its disposal. Ascertain amount of space at the disposal of the enterprise which is used for business activities is sufficient to constitute a place of business. No formal legal right to use that place is required. (Para 34, while discussing OECD Commentary).

6.2 *Sedco Forex International Inc vs. CIT*

6.2.1 Taxation of certain specific receipts under Section 44BB has always been a matter of dispute between the Revenue and the taxpayer. The Supreme Court in a recent decision dated 30/10/2017 in the case of *Sedco Forex International Inc vs. CIT* and others *(*Civil Appeal No. 4906 of 2010 and others), has held that the mobilization fees received for transportation of rigs for providing services and facilities in connection with the extraction of mineral oil in India are taxable under Section 44BB of the Act.

6.2.2 Facts of the Case

6.2.2.1 The taxpayer, a non-resident company was engaged in executing contracts all over the world including India for providing services and facilities in connection with exploration and production of mineral oil. The provisions of Section 44BB of the Act are applicable to non-resident taxpayers engaged in the business of providing services and facilities in connection with exploration etc. of mineral oil.

6.2.2.2 The taxpayer entered into contracts primarily with Oil and Natural Gas Commission (ONGC) for hire of their rig for providing services and facilities in connection with exploration activities in India. The aforesaid agreements provided for the scope of work along with separate consideration for the work undertaken.

6.2.2.3 During the year under consideration, the taxpayers were paid a mobilization fees for and on account of mobilisation/ movement of rig from foreign soil/ country to the off-shore site at Mumbai.

6.2.2.4 The taxpayer did not include the amount received as mobilization charges in the gross revenue for the purpose of computation under Section 44BB of the Act.

6.2.2.5 The AO included the amounts received for mobilization/ demobilization to the gross receipts to arrive at the 'Profits and Gains' for the purpose of computing tax under Section 44BB of the Act.

The CIT(A) and the ITAT upheld the action of the AO.

6.2.3 Decision of the High Court

The High Court also held that the mobilization charges reimbursed inter alia even for the services rendered outside India were taxable under Section 44BB of the Act. It also made an observation that taxability of such income is not governed by the charging provisions of Section 5 and 9 of the Act.

6.2.4 Decision of the Supreme Court

6.2.4.1 The taxpayer filed further appeal before the Supreme Court in which following were the broad issues for consideration:

1. Whether mobilization fees is a reimbursement of expenditure actually incurred by the taxpayer?
2. Whether taxability of mobilization fees shall be examined only under Section 44BB of the Act or also under the provisions of Section 5 and 9 of the Act?

6.2.4.2 The Supreme Court decided both the issues in favour of the Department. It ruled that the mobilization fees was not a reimbursement of expense. The Supreme Court also held that amount received for mobilization of a rig was to be included to the gross revenue to arrive at the 'profits and gains' for the purpose of computing tax under Section 44BB of the Act.

6.2.4.3 Following are the key takeaways of the ruling:

a. The Supreme Court held that as per the agreement, the mobilization fees was payable for the mobilization of the drilling unit from the place of origin to the port of entry. A *fixed amount* of mobilization fees was payable under the contract as compensation. As the same is a fixed amount paid, which may be less or more than the expenses incurred, the same is not reimbursement of expenses.

b. The High Court in this case had held that the provisions of Sections 5 and 9 of the Act are not attracted in the instant case, as the taxability of mobilisation charges are government by Section 44BB of the Act. However, the Supreme Court held that the High Court, may not be entirely correct in law in excluding the provisions of Sections 5 and 9 of the Act in cases where the assessment is opted by the taxpayer under Section 44BB of the Act.

c. Section 44BB of the Act provides for special provision for computing profits and gains. However the Supreme Court observed that Sections 4, 5 and 9 of the Act which deal with charging Section, total income and income of non-resident which arises or deems to arise in India cannot be side tracked. These are the provisions which bring a particular income within the net of Income-tax. Therefore, it is imperative that a particular income is covered by the provisions contained in Section 5 of the Act.

d. The Supreme Court observed that the Act follows a territorial system of taxation. As per this system only that income of a non-resident is taxable in India which is attributable to operations within the Indian territory. Therefore, in the *first instance* it is to be seen whether a particular income arises or accrues or deems to arise or accrue within India. Accordingly, in case of a non-resident, the principles contained in Section 9 of if the Act have to be applied and only then it becomes an income taxable in India as per Section 9 of the Act. The *question of computation of the said income would arise only after determining the taxable income in India as per the provisions of Section 9 of the Act.*

e. Section 44BB(2) of the Act makes certain receipts as 'deemed income' for the purposes of taxation in the said provision. Therefore, aid of this provision is to be necessarily taken to determine whether a particular amount will be 'income' within the meaning of Section 5 of the Act. Section 44BB(2) also acts as a guide to determine whether a particular income is attributed as income occurred in India.

f. From the bare reading of the clauses of Section 44BB of the Act, the amount paid under the aforesaid contracts as mobilization fee on account of provision of services and facilities in connection with the extraction, etc. of mineral oil in India and against the supply of plant and machinery on hire used for such extraction, falls under Section 44BB(2)(a) of the Act.

g. Thus, the provisions of Section 44BB has to be read in conjunction with Sections 5 and 9 of the Act and Sections 5 and 9 of the Act cannot be read in isolation. The aforesaid amount paid to the taxpayers as mobilization fee is treated as profits and gains of business and therefore it would be 'income' as per Section 5 of the Act. This

provision also treats this income as earned in India, fictionally, thereby satisfying the test of Section 9 of the Act as well.

h. When it is found that the amount paid or payable (whether in or out of India), or amount received or deemed to be received in India is covered by Sub-section (2) of Section 44BB of the Act, by fiction created under Section 44BB of the Act, it becomes 'income' under Sections 5 and 9 of the Act as well.

7. DEDUCTION OF TAX AT SOURCE ON PAYMENTS TO NON-RESIDENTS

7.1 In international taxation charges the issue of deduction of withholding tax on payments to non-residents arises for examination when the applicants file applications under Section 195/197 of the Act w.r.t. such payments to non-residents.

7.2 Except for TDS on certain specific receipts in the hands of non-residents dealt separately e.g. in Section 194LB, 194LC etc., Section 195(1) deals with obligation to deduct taxes on payments to non-residents. The salient features of Section 195(1) is that there is no threshold limit on the quantum of sum under consideration. Unlike other TDS provisions this provision uses the special phrase *"any sum chargeable under the provisions of this Act"*. Further, unlike other Sections there is no prescribed rate of taxation-tax is to be deducted at the rates in force. To apply this Section effectively required an understanding of both the Act and the DTAA.

7.3 The obligation to deduct TDS under Section 195(1) on payments to non-residents is on 'any person'. In the case of Vodafone International Holdings (SC) it was held that obligation to deduct TDS under Section 195 will only apply when payment is from a resident to non-resident and not when the transaction is between two non-residents situated outside India. *Explanation* 2 inserted vide Finance Act 2012 specifies that 'any person' covers payments to a non-resident made by any person, whether non-resident or resident.

7.4 A Payer, who is responsible for making payment to non-resident can make an application to the Assessing Officer to determine the appropriate portion of income chargeable to tax under Section 195(2), if he considers that the whole of such sum would not be income chargeable in the case of the non-resident recipient. Under Section 195(3), a recipient may make an application for the grant of certificate authorizing him to receive interest or other sum on which Income-tax has to be deducted under Section 195(1), without deduction of taxes. This is specifically applicable to specified foreign banking company and specified persons carrying on business/ profession through PE in India. Thus while application under Section 195(2) is made by a payer for determining the appropriate portion of income chargeable to tax, application under Section 195(3) is made by a certain category of recipients *for issue of* nil deduction certificate.

7.5 Section 197 is the general Section under which an assessee (for the issue under consideration the recipient non-resident company) makes an application for issue of certificate for nil deduction of taxes or deduction of taxes at lower rates, than as provided under the various provisions of Chapter XVII.

7.6 The above applications are to be made in specified Forms (e.g. Form 13) and specific conditions may need to be satisfied in each cases under various Rules (e.g. Rule 26, 29B etc.). Each application needs to be examined as to whether the sums under consideration are taxable in India and if so, under what head and at what rates. Based on the date a certificate for deduction of tax at certain rates or no deduction of taxes is issued. In determining the tax rates so applicable, whether the assessee is eligible for treaty benefits also needs to be examined.

7.7 In many cases of payments to non-residents, often under arrangement it thewithholding taxes on payments are to be borne by the payer and the consideration or sum which is to be paid to the non-resident assessee, is after taking into account such withholding taxes if any. In such cases under Section 195A, for the purpose of computing TDS, the income or payment is grossed up and increased to such an amount as would, after deduction of taxes thereon, be equal to the net amount payable under such an agreement.

REFERENCES

[1] https:// en.wikipedia.org/ wiki/ Treaty
[2] http:// www.un.org/ esa/ ffd/ documents/ UN_Model_2011_Update.pdf
[3] https:// scholarship.law.berkeley.edu/ cgi/ viewcontent.cgi?article=1039&context=bjil
[4] http:// www.in.kpmg.com/ taxflashnews/ KPMG-Flash-News-Sedco-Forex-International-Inc-2.pdf
[5] Commentaries-Klaus Vogel on Double Taxation Conventions

CHAPTER

8

Business Re-organisation (Mergers, Acquisitions and Demergers)

1. INTRODUCTION

1.1 Corporate re-organisation by way of mergers and acquisitions can be said to have begun as early as the 1980s with some well-known hostile takeover attempts but witnessed a spurt post liberalization of 1990s. A merger occurs when two separate corporate entities combine forces to create a new, joint organisation. In an acquisition, a new company does not emerge. Instead, the smaller company is often consumed and ceases to exist with its assets becoming part of the larger company. Mergers and acquisitions may be completed to expand a company's reach or gain market share in an attempt to create shareholder value. The acquisition of Tata Oil Mills Company by Hindustan Levers Limited, Tata Steel's takeover of European major steel producer Corus, Vodafone's takeover of Hutchison-Essar, Hindalco's acquisition of Canadian aluminum company Novelis, acquisition of Indian pharma major Ranbaxy by Daiichi Sankyo of Japan, acquisition by Mahindra & Mahindra of German forging company Schoneweiss, acquisition by Tata Motors of Jaguar Land Rover of England and the recent merger of Idea with Vodafone are some of the example of Mergers & Acquisitions (M&As) in the Indian context.

1.2 In the Indian context, M&As can be structured in different ways and the tax implications vary based on the structure that has been adopted for a particular acquisition. The methods by which an acquisition can be undertaken are:

i. **Merger:** This entails a court approved process whereby one or more companies merge with another company or two or more companies merge together to form one company.

ii. **Demerger:** This entails a court approved process whereby the business/ undertaking of one company is demerged into a resulting company.

iii. **Share Purchase:** This envisages the purchase of the shares of the target company by an acquirer.

iv. **Slump Sale:** A slump sale is a sale of a business/ undertaking by a seller as a going concern to an acquirer, without specific values being assigned to individual assets.

v. **Asset Sale:** An asset sale is another method of transfer of business, whereby individual assets/ liabilities are cherry picked by an acquirer.

1.3 The terms merger, acquisition and takeovers are often used interchangeably in corporate restructuring in India. Merger involves absorption of one company by another or amalgamation of two companies to form a new company. It involves transfer of entire assets, liabilities and employees of amalgamating company to the amalgamated company. Subject to judicial approvals, the Transferor Company is automatically wound up and no separate liquidation proceedings are required. Mergers or amalgamations, result in the combination of two or more companies into one, wherein the merging entities lose their erstwhile identities. A *merger* is a process to consolidate multiple businesses into one business entity. All the *Amalgamations* are part of the *Merger***.** It is a type of *merger* process in which two or more companies combine together to form a new entity. All the *mergers* are not *Amalgamation***.** No fresh investment is made though an exchange of shares takes place between the entities involved. *Acquisition* on the other hand is the taking possession of another business also called a takeover or buyout. This may be *through share purchase* (the buyer buys the shares from the shareholders of the target company so that the buyer takes over the company with all its assets and liabilities) or *through asset purchase* (buyer buys the specific cherry picked assets from the target company). The shares can be purchased in cash or by exchange of shares. In some cases, instead of purchase of entire shareholding of the target company, the two companies amalgamate and shares of the resulting company is allotted in appropriate ratio to the erstwhile shareholders of the merged company. This is the case of "*Merger*" or "*Amalgamation*".

1.4 In some of the scenario, a business entity transfers assets and liabilities of one or more of its undertakings to another business entity for business reorganization, which is popularly known as *"Demerger"*. This is relatively a new phenomenon in Indian corporate sector. Mergers/ Amalgamations/ Demergers are court approved process under the Companies Act, 2013.

1.5 The Income-tax Act defines the word "amalgamation", "demerger" and "slump sale". The popular forms of business reorganisation/ restructuring in India can be undertaken by way of amalgamation, merger, demerger, share purchase, assets purchase (slump sale), etc.

The key motives behind business reorganisation/ restructuring in commercial sense are:

a. Gain more competitive position.
b. Business synergies.
c. Inorganic growth.
d. Exit non-core businesses.
e. Achieve economies of scale.
f. Stake enhancement and exit.
g. Greater control over assets and operations.
h. Strategic alliances/ partnerships.
i. Increasing shareholder value.

The key motives behind business reorganisation/ restructuring in finance/ taxation sense are:

a. Synergies in cost.
b. Improved fund flow.
c. Higher dividends to promoters.
d. Encashing value.
e. Tax savings.

The judicial pronouncements have held that every 'person' is entitled to do what he can to order his affairs so that the tax liability is minimized.

2. LAWS RELATING TO BUSINESS REORGANISATION IN INDIA

2.1 The following regulations and legislations are some of the important ones covering the business reorganization:

i. The Companies Act, 2013

ii. The Income-tax Act, 1961

iii. SEBI, (Substantial Acquisition of Shares & Takeovers) Regulation, 2011

iv. The Competition Act, 2002

v. Insolvency and Bankruptcy Code, 2016

vi. The Accounting Standard (AS)-14

Sections 230 to 240 of The Companies Act, 2013 deal with situations and procedures of mergers & amalgamations. Under the new Companies Act 2013, the National Company Law Tribunal (NCLT) has assumed the jurisdiction of the High Courts in the context of the restructuring schemes to grant the requisite approvals. The Act requires the Accounting Standards to be followed and scheme of amalgamation & merger along with the valuations etc. to be intimated to the Income-tax authorities, the Reserve Bank of India, the Securities and Exchange Board, the Registrar, the respective stock exchanges, the Official Liquidator, the Competition Commission of India who can file objections before the NCLT within 30 days from the date of receipt of such information.

The SEBI regulations are applicable to listed companies. Sections 5, 6 & 30 of the Competition Act deal with regulation of business combinations. The Insolvency and Bankruptcy Code, 2016, the successor to the BIFR under the Sick Industrial Companies Act, 1985 (which has been repealed), deals with insolvency of companies, firms and individuals, and has repealed the provisions of the Companies Act, 2013 dealing with sick companies. The NCLT deals with the insolvency resolution process under the IBC Code.

2.2 Importance of Appointed Date

Every scheme of amalgamation has to necessarily provide a date with effect from which the amalgamation shall take place. In the case of amalgamation of running companies it is the 'Appointed Date' which segregates the liabilities of the transferor and transferee companies. This date assumes a great importance on account of the following factors:

i. It is from this date that all the assets and liabilities of the transferor company vest with the transferee company.

ii. The exchange ratio of both the companies is worked out on the basis of the assets and liabilities position on the appointed date.

iii. The Appointed Date acts as a cutoff date and even though the scheme of amalgamation is approved at later date, it takes effect from the appointed date.

In the decision rendered in *Marshall Sons* & Co. *(India) Ltd. vs. ITO* (1997) reported in 223 ITR 809, the Hon'ble Supreme Court held that where the Court does not prescribe any specific date, but merely sanctions the scheme presented to it, then the date of amalgamation/ date of transfer is the date specified in the scheme. It was also held that the proceedings before the Court may take some time and during the period the proceedings are pending, both the Transferor Company and the Transferee Company may carry on business, but normally provision is made for this aspect in the scheme of amalgamation. The Hon'ble Apex Court observed as under:

> *"Counsel for the Revenue contended that if the aforesaid view is adopted then several complications will ensue in case the Court refuses to sanction the scheme of amalgamation. We do not see any basis for this apprehension. Firstly, an assessment can always be made and is supposed to be made on the Transferee Company taking into account the income of both the Transferor and Transferee Company. Secondly, and probably*

the more advisable course from the point of view of the Revenue would be to make one assessment on the Transferee Company taking into account the income of both of Transferor or Transferee Companies and also to make separate protective assessments on both the Transferor and Transferee Companies separately. There may be a certain practical difficulty in adopting this course inasmuch as separate balance-sheets may not be available for the Transferor and Transferee Companies. But that may not be an insuperable problem inasmuch as assessment can always be made, on the available material, even without a balance-sheet. In certain cases, best-judgment assessment may also be resorted to."

3. PROVISIONS OF INCOME-TAX ACT RELATING TO REORGANIZATION OF BUSINESS

The main intention of the legislature was to recognise the need for restructuring of business without having any tax incidence. Accordingly, several provisions are there in the Act on reorganisation of business to enable the restructuring tax neutral subject to fulfilling specified conditions failing which tax liability would be attracted. The tax laws are regularly being amended from time to time as per the changed scenario. The relevant provisions of the Act are discussed below.

3.1.1 Merger and Amalgamation

According to Section 2(1B)of the Income-tax Act, 1961 (hereinafter referred to as the 'Act'), the Amalgamation is defined as under:

"amalgamation", in relation to companies means the merger of one or more companies with another company or the merger of two or more companies to form one company (the company or companies which so merge being referred to as the amalgamating company or companies and the company with which they merge or which is formed as a result of the merger, as the amalgamated company) in such a manner that:

i. *all the property of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamated company by virtue of amalgamation;*

ii. *all the liabilities of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamated company by virtue of amalgamation;*

iii. *shareholders holding not less than 3/4th in value of the shares in amalgamating company or companies (other than shares held therein immediately before the amalgamation or by a nominee for the amalgamated company or its subsidiary) become shareholders of the amalgamated company by virtue of the amalgamation,*

otherwise than as a result of the acquisition of the property of one company by another pursuant to the purchase of such property by the other company or as a result of distribution of such property to the other company after the winding up of first mentioned company.

(In the subsequent paragraphs, the amalgamating company is referred as transferor company while the amalgamated company is referred as transferee company)

3.1.2 Demerger

According to Section 2(19AA) of the Income-tax Act, 1961, the Demerger is defined as under:

"demerger", in relation to companies, means the transfer, pursuant to a scheme of arrangement under Sections 391 to 394 of the Companies Act, 1956 (1 of 1956), by a demerged company of its one or more undertakings to any resulting company in such a manner that—

i. *All the property of the undertaking, being transferred by the demerged company, immediately before the demerger, becomes the property of the resulting company by virtue of the demerger;*

ii. *All the liabilities relatable to the undertaking, being transferred by the demerged company, immediately before the demerger, become the liabilities of the resulting company by virtue of the demerger;*

iii. *The property and the liabilities of the undertaking or undertakings being transferred by the demerged company are transferred at values appearing in its books of account immediately before the demerger;*

Provided that the provisions of this sub-Clause shall not apply where the resulting company records the value of the property and the liabilities of the undertaking or undertakings at a value different from the value appearing in the books of account of the demerged company, immediately before the demerger, in compliance to the Indian Accounting Standards specified in Annexure to the Companies (Indian Accounting Standards) Rules, 2015;

iv. *The resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis (except where the resulting company itself is a shareholder of the demerged company);*

v. *The shareholders holding not less than three-fourths in value of the shares in the demerged company (other than shares already held therein immediately before the demerger, or by a nominee for, the resulting company or, its subsidiary) become share-holders of the resulting company or companies by virtue of the demerger, Otherwise than as a result of the acquisition of the property or assets of the demerged company or any undertaking thereof by the resulting company;*

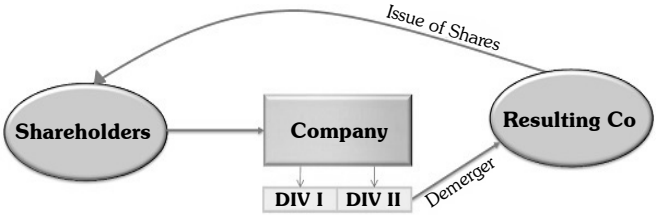
vi. *The transfer of the undertaking is on a going concern basis;*

vii. *The demerger is in accordance with the conditions, if any, notified under Sub-section (5) of Section 72A by the Central Government in this behalf.*

Explanation 1.—For the purposes of this Clause, "undertaking" shall include any part of an undertaking, or a unit or division of an undertaking or a business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity.

The company whose undertaking is transferred under scheme of demerger, is known as demerged company *Section 2(19AAA)* and the company in which the undertaking of the demerged company is transferred, is known as resulting company *Section 2(14A)*

This is illustrated below.



3.1.3 Slump Sale

Section 50B and 2(42C) deal with slump sale. According to Section 2(42C) of the Income-tax Act, 1961, the Slump Sale is defined as under:

"Slump sale" means the transfer of one or more undertakings as a result of the sale for a lump sum consideration without values being assigned to the individual assets and liabilities in such sales.

However, explanation 2 states that the determination of value of an asset or liability

for the sole purpose of payment of stamp duty, registration fees or other similar taxes or fees shall not be regarded as assignment of values to individual assets or liabilities.

Thus while in a demerger consideration is by way of issue of shares to the shareholders, in case of Slump Sale, monetary consideration is paid to company transferring the undertaking and capital gains arising–long term or short term is liable to tax. Further in the case of 'Slump sale', the undertaking which is a viable business unit is transferred which includes its assets and liabilities whereas 'asset sale' involves only sale of specified assets and not a business undertaking.

Landmark decision is *CIT vs. Artex Mfg. Co.* (1997) 227 ITR 260(SC) wherein it was held that If value is assigned to individual assets and liabilities, it is not a slump sale. In the case of *Mahindra Sintered Products Ltd.* ([2005] 95 ITD 0380) it was held that where the price was fixed beforehand in respect of identifiable assets of the undertaking and no liabilities were transferred to the buyer, transfer of undertaking would not be regarded as a slump sale. Similarly, in the case of *Weikfield Products Co. (I) (P) Ltd.* ([2001] 71 TTJ 0518*),* sale of business was not considered to be a Slump Sale because there was only a transfer of assets without liabilities. However, in the case of *Triune Projects Pvt. Ltd vs. DCIT* ([2017] 291 CTR 0268 [Del]) the Delhi High Court held that for a sale to be termed a 'slump sale', it is not necessary to transfer all assets and liabilities. However, the core elements of the business must be transferred for a lump sum price, and the transferee must be able to continue the business on going concern basis without the assets that have not been transferred. The Special Bench of ITAT Mumbai in case of Summit Securities Ltd. ((2012) 135 ITD 0099 (SB)), opined that the negative net worth of an undertaking cannot be equated to zero and the same should be added to the sale consideration to arrive at capital gains. The Bombay High Court has held that for any transaction to be considered as 'slump sale', an essential element is that the transfer of the undertaking must be for cash consideration. The High Court, while referring to an earlier judgment of the Supreme Court held that a transfer of an undertaking in exchange for shares/ bonds of the transferee entity would not constitute a 'sale' and accordingly, it would not be taxed as a slump sale under Section 50B of the Income-tax Act *(Bharat Bijlee Limited vs. The Addl. CIT* (ITA No. 2153 of 2011)).

3.1.4 Asset Sale

As compared to slump sale discussed above, an asset sale is an itemized sale of the assets of company or a piecemeal sale of the assets of the company. In an itemized sale of assets, for determining taxability of capital gains, a distinction is drawn between depreciable and non-depreciable assets.

a. Non-depreciable Assets

On sale of all assets not being depreciable assets, capital gains are calculated as per Sections 45 and 48 of the Income-tax Act, i.e., the amount by which the sale consideration of the asset exceeds its cost of acquisition. Each asset is assigned a value, and the consideration for such asset is also determined. The gains from the sale of each asset is determined and the transferor is liable to capital gains tax on the gains (if any) from the sale of each asset. Further, whether the sale would result in short term or long term capital gains would need to be analyzed individually depending on the holding period for each asset by the transferor.

b. Depreciable Assets

When an asset forms a part of a block of assets on which depreciation is allowed as deduction at the rate applicable on the block, the capital gains arising from such transfer are taxed only as short-term capital gains irrespective of the period of holding of the asset. The capital gains from transfer of depreciable assets are determined as the difference, if any, between the sale consideration from the transfer of the concerned assets, together with the transfer of any other

asset within that block in the same financial year, and the aggregate of (i) expenditure incurred in connection with such transfer, (ii) depreciated value of the concerned block of assets at the beginning of the financial year, and (iii) actual cost of any asset acquired during that year and forming part of that block. "Block of Assets" is defined in Section 2(11) of the Income-tax Act as a group of assets falling within a class of assets in respect of which the same percentage of depreciation is prescribed. Such block of assets may comprise of (a) tangible assets such as buildings, machinery, plant or furniture; (b) intangible assets such as knowhow, patents copyrights etc. If the sale consideration does not exceed the aggregate of the above values, then there is no capital gains which are said to arise from the sale of the asset even if the sale consideration exceeds its cost of acquisition. In such a situation the sale consideration is adjusted within the block and the value of the block is reduced by the amount of sale consideration of the asset.

3.1.5 Share Sale

This is a case of share acquisition, which involves the acquisition of the shares of the company in which the target business is vested. The entire company is sold lock, stock and barrel. The major tax implications of share acquisition are (i) liability to a tax on the capital gains and (ii) liability under Section 56(2)(viia)/ 56(2)(x) of the Income-tax Act, if applicable (sale below FMV).

If the shares qualify as capital assets under Section 2(14) of the Income-tax Act, gains arising upon the transfer of shares would attract a capital gains tax liability. The taxable rate in India would depend on (i) whether the capital gains are long term capital gains or short term capital gains, (ii) whether the target company is a public listed company, public unlisted company or a private company, (iii) whether the transaction has taken place on the floor of the stock exchange or by way of a private arrangement, and (iv) whether the seller is a resident or a non-resident. Further, in respect of a cross-border share sale, the relevant Double Taxation Avoidance Agreement ("DTAA") would determine whether capital gains are taxable in India or in the other country.

A chart showing comparison of the different methods is given in the Annexure at the end of this chapter.

3.2 Taxation on Transfer of Capital Asset

In order to reduce the hardship to the business reorganization, several tax concessions have been provided in the Act which are discussed below.

3.2.1 Section 47 of the Act deals with the exemptions from capital gains in the hands of the Transferor Company, demerged company and shareholders of transferor & demerged company. Section 47 provides specific exemption with respect to transactions involving amalgamation/ demerger and following transfers are exempt from the capital gain (Section 45):

i. Any transfer of a capital asset in a scheme of amalgamation if both amalgamating company and amalgamated company are Indian companies (*Section 47 (vi)*).

ii. Any transfer of a capital asset, being shares held in an Indian company, in a scheme of amalgamation by a foreign amalgamating company to the foreign amalgamated company with fulfillment of certain conditions (*Section 47 (via)*).

iii. Any transfer of a Banking Company with a Banking Institution sanctioned by the Central Government (*Section 47 (viaa)*).

iv. Similar exemption is allowed in respect of transfer of shares in a foreign company whose value is derived directly or indirectly substantially from shares held in an Indian company by the amalgamating foreign company with fulfillment of certain conditions (*Section 47 (viab)*).

v. Any transfer of a capital asset in a scheme of demerger by the demerged company to the resulting Indian company (*Section 47 (vib)*).

vi. Any transfer of a capital asset, being shares held in an Indian company, in a scheme of demerger by the demerged foreign company to the foreign resulting company with fulfillment of certain conditions *(Section 47 (vic)*).

vii. Similar exemption is allowed in respect of transfer of shares in a foreign company whose value is derived directly or indirectly substantially from shares held in an Indian company by the demerged foreign company with fulfillment of certain conditions ***(****Section 47 (vicc)****).***

viii. Any transfer or issue of shares by the resulting company, in a scheme of demerger, to the shareholder of the demerged company in consideration of demerger of the undertaking ***(****Section 47 (vid)****).***

ix. Any transfer by a shareholder, in a scheme of amalgamation, of a capital asset being a share or shares held by him in the amalgamating company will not be regarded as transfer and hence exempt from capital gains tax if the transfer is made in consideration of the allotment to him of any share or shares in the amalgamated company and the amalgamated company is an Indian company ***(****Section 47 (vii)****).***

3.2.2 If the conditions enumerated in Section 47 or 2(42C) of the Act are not fulfilled, the transaction in the scheme of amalgamation or demerger or slump sale shall be treated as transfer of the capital asset and accordingly, capital gain on such transfers shall be liable to be taxed. For the purpose of computation of the capital gain, the Act provides specific provisions relating to cost of the assets, period of holding of the assets, etc., which are discussed as under:

i. **Section 49(2)** deals with the cost of the capital assets being shares in the hands of the shareholders under the amalgamation. The cost of shares in the transferor company in the hands of shareholders will be the cost of the shares in the transferee company received on amalgamation.

ii. **Section 49(2C)** deals with the cost of acquisition of the shares of the resulting company in the hands of shareholders under the demerger. The cost of acquisition of shares in the resulting company shall be the amount which bears to the cost of acquisition of shares in the demerged company the same proportion as the net book value of the assets transferred in a demerger bears to the net worth of the demerged company immediately before such demerger. Section 49(2D**)** further provides that the cost of acquisition of the original shares held by the shareholder in the demerged company shall be deemed to have been reduced by the amount as so arrived at under Sub-section (2C).

iii. **Explanation 1 to Section 2(42A)** deals with the period of holding of shares in the hands of the shareholders of the both transferor company and demerged company. The holding period in the transferor company/ demerged company shall also be considered for the purpose of computing the holding period in respect of shares of the transferee company/ resulting company received on the amalgamation/ demerger.

iv. **Section 49(1)(iii)(e)** deals with the cost of acquisition of the assets and depreciation in the books of the transferee company/ resulting company for the assets transferred on amalgamation/ demerger in following ways:

a. Where any block of assets is transferred pursuant to the amalgamation/

demerger, the opening written down value of the block of assets transferred by the transferor company/ demerged company will be written down value of the block for the transferee company/ resulting company.

b. For any non-depreciable asset, the cost in the books of the transferor company/ demerged company is available as the cost of the books of the transferee company/ resulting company.

v. **Section 50B** deals with the computation of capital gains in case of slump sale. Any profits or gains arising from transfer of an undertaking/ undertakings under slump sale shall be deemed to be short term capital gains, if the said undertaking was owned and held for not more than thirty-six months immediately before the date of its transfer. Further, net worth of the undertaking shall be deemed to be the cost of acquisition and cost of improvement and any revaluation of assets shall not be considered for the purpose of net worth.

3.3 Allowability of Certain Expenditures: Expenses mentioned below will be allowed in the hands of the Transferee Company/ Resulting Company, as they were to be allowed in the hands of the Transferor Company/ Demerged Company, as if the amalgamation would not have taken place:

i. **Section 32:** Proviso 6 to Section 32 (1) provides that the depreciation on assets acquired under amalgamation or demerger shall not exceed the deduction which would have been allowed to the Transferor Company/ demerged company, had the amalgamation/ demerger not taken place.

ii. **Section 35(5):** Capital Expenditure on Scientific Research, provided the amalgamated company is an Indian Company and the asset continues to be used by it for the purpose of scientific research relating to the business carried on by it.

iii. **Section 35A(6) and 35A(7):** Expenditure on Acquisition of Patent or Copyright is allowable in the hands of the Transferee Company/ Resulting Company.

iv. **Section 35AB(3):** the Transferee Company/ Resulting Company is entitled to deduction of Expenditure on know-how to the same extent and in respect of the residual period as it would have been allowable to the Transferor Company/ Demerged Company as the case may be had such amalgamation/ demerger not taken place. This deduction is available only if expenditure is incurred before 01/04/1998. If expenditure is incurred after 31/03/1998, depreciation is available under Section 32 of the Act.

v. **Section 35D(5) and 35D(5A):** Amortization of Preliminary Expenses in the hands of the Transferee Company/ Resulting Company instead of the Transferor Company/ Demerged Company for the previous year in which the amalgamation/ Demerger takes place.

vi. **Section 35DD:** Expenditure on Amalgamation or Demerger is allowable in the hands of the Transferee Company in five successive years equally.

vii. **Section 36(1)(vii):** The deduction for bad debts of the Transferor Company/ Demerged Company is allowable in the hands of the Transferee Company/ Resulting Company as per the ratio laid down by the Hon'ble SC in the case of *CIT vs. Veerabhaadhra Rao, K. Koteswara Rao and Co.* (1985) 155 ITR 152 (SC).

3.4 Section 41(1)(b)—Profits Chargeable to Tax on Cessation of Liability in the Hands of the Successor or Transferee or Resulting

Company: Section 41(1)(b) provides that where an allowance or deduction has been claimed for any year in respect of loss, expenditure or trading liability incurred by the transferor or demerged company, then any cessation or remission of liability after amalgamation or demerger shall be deemed to be the profits and gains of the business in the hands of transferee or resulting company.

3.5 Tax Holiday Benefits i.e. Deduction under Section 10A, 10AA, 10B, 80-IA, 80-IB and 80-IC: If a company which is entitled for deduction under various provisions of the Act is transferred on amalgamation or demerger, the benefit of tax holiday shall not be lost for the unexpired period. The Act provides the continuity of tax holiday where any undertaking is transferred before the expiry of tax holiday period in pursuant to amalgamation or demerger, which is summarized as under:

i. Deduction under Section 10A, 10B, 80IA, 80IB and 80-IC for tax holiday benefit would be available to the Transferee Company (i.e. amalgamated company)/ resulting company for the unexpired period (including the previous year in which amalgamation/ demerger takes place).

ii. Similarly, deduction under Section 10AA shall be allowable in the hands of the Transferee Company (i.e. amalgamated company)/ resulting company for the unexpired period. But there is one difference that no deduction shall be admissible under this Section to the transferor (amalgamating) company/ demerged company in the previous year in which the amalgamation/ demerger takes place (*Section 10AA(5)*).

iii. The tax holiday benefit is available only when both transferor (amalgamating)/ demerged and transferee (amalgamated)/ resulting company are Indian companies.

iv. The tax holiday benefit under Section 80IA shall not be available to transferor company/ demerged company as well as transferee company/ resulting company on or after 01/04/2007 (*Section 80IA(12A)*).

3.6.1 Section 72A—Carry Forward and Set-off of Accumulated Loss and Unabsorbed Depreciation: For encouraging revival and rehabilitation of techno-economically viable but financially weak companies, specific provisions were embodied in Section 72A of the Income-tax Act, 1961 whereby the accumulated losses and unabsorbed depreciation of the amalgamating company/ demerged company shall be deemed to be the loss, or as the case may be, allowance for depreciation, of the transferee (amalgamated) company/ resulting company for the previous year in which the amalgamation/ demerger was effected provided certain conditions are fulfilled. In this process, the transferee company/ resulting company can reduce its taxable profit to the extent of accumulated loss and unabsorbed depreciation of the transferor company/ demerged company. Thus the transferee company/ resulting company avoids paying huge taxes to the exchequer as an incentive.

A. The requisite conditions for availing these benefits by the transferee company in the scheme of amalgamation are as under:

i. The transferor company has been engaged in the business for three or more years.

ii. The transferor company has held continuously as on the date of the amalgamation at least three-fourths of the book value of fixed assets held by it two years prior to the date of amalgamation.

iii. The transferee company continues to hold at least three-fourths of the book value of fixed assets of the transferor company for five years from the effective date of amalgamation, which is acquired as a result of amalgamation.

iv. The transferee company continues the business of the transferor company for a

minimum period of 5 years from the date of amalgamation.

v. The transferee company shall achieve the level of production of at least 50 Per cent of the installed capacity of the transferor company before the end of 4 years from the date of amalgamation and continue to maintain the said minimum level of production till the end of 5 years from the date of amalgamation.

If the transferee company fails to comply with any condition mentioned above, the set off of loss or allowance of depreciation made in any previous year in the hands of transferee company shall be deemed to be the income of the transferee company chargeable to tax for the year in which such conditions are not complied with (*Section 72A(3)*).

B. In the case of demerger, the following two conditions are required to be fulfilled for carry forward of accumulated loss and unabsorbed depreciation in the hands of the resulting company:

i. Where the accumulated loss or unabsorbed depreciation is directly relatable to the undertakings transferred to the resulting company, whole of such loss or unabsorbed depreciation be allowed to be carry forward and set off in the hands of the resulting company.

ii. Where the accumulated loss or unabsorbed depreciation is not directly relatable to the undertakings transferred to the resulting company, proportionate loss or unabsorbed depreciation in the same proportion in which the assets of the undertakings have been retained by the demerged company and transferred to the resulting company be allowed to be carry forward and set off in the hands of the resulting company.

3.6.2 Section 79—Carry forward and Set off of Losses on Substantial Change in Shareholding: Section 79 of the Act provides that where there is change in the shareholding of a company in a financial year, no business loss incurred in any prior financial year shall be carried forward and set off against the income of the financial year in which the shareholding has changed, unless the same person beneficially held 51 Per cent of the voting rights of the company as on the last day of the financial year as well as on the last day of the financial year when the losses were incurred. Second Proviso to the Section 79 further provides for exemption in respect of change in shareholding of an Indian company which is a subsidiary of a foreign company as a result of amalgamation or demerger of a foreign company if 51% of the shareholders of the amalgamating (transferor) or demerged foreign company continue to be shareholders of the amalgamated (transferee) or resulting foreign company.

There is no specific provision for carry forward of loss under the head 'house property' or 'capital gain' of the transferor company to the transferee company. Hence, the same will get lost and neither company can avail it. In case of *Clariant Chemicals (I) Ltd. vs. ACIT* (2015) 152 ITD 191 (Mumbai-Trib.), it has been held by the Mumbai ITAT that with regard to loss under the head 'Capital Gain' there was no mention about a situation and condition under which such a loss was allowed to be set off and carried forward in case of amalgamation.

3.6.3 Depreciation on Goodwill Arising in Amalgamation

3.6.3.1 Strategic acquisition of a target, by an acquirer paying more than its book net worth, is common in merger and acquisition deals. The acquisition price is generally based on the fair market value of business. The excess price is paid on account of various factors such as brand, clientele, combined synergies, etc., which may not be recorded in the books of account

by the target. Such excess price, i.e. purchase price that exceeds the value of net assets, is recorded as 'goodwill' in the books of account of the acquirer. In many deals depreciation on such goodwill is seen as an incentive for carrying out merger and acquisition and is often termed as tax planning. However, as per the provisions of the Income-tax Act, the so called tax planning is actually an incorrect claim for depreciation which needs to be disallowed.

3.6.3.2 This can be illustrated with an example. PCo is the parent company and SCo is its subsidiary. Both are Indian companies. PCo gets merged with SCo. The merger qualifies as amalgamation under Section 2(1B) of the Income-tax Act thus SCo is amalgamated company and PCo is amalgamating company. The investment of PCo in SCo was appearing as asset before amalgamation; let us say at Rs. 100. The asset of PCo was Rs. 60. At the time of merger, the valuation of PCo is done and it comes to Rs 110. SCo would now show the acquired assets at Rs. 60 and the balance Rs. 50 would appear on the asset side as "Goodwill" and on liability side as "Share Capital and Premium". Thus, without any physical exchange of money, only by book entry goodwill has been created in the books.

3.6.3.3 The scheme of the Act is such that when the merger qualifies as amalgamation, there would neither be capital gains nor depreciation on Goodwill. Capital gains exemption is available under Section 47(v) or 47(vi) of the Act. However depreciation is not allowable on goodwill of Rs. 50 as per the provisions in the Act.

3.6.3.4 The assessee may claim that they are eligible for depreciation on such goodwill under Section 32(1)(ii) of the Act. The claim is that Goodwill qualifies for depreciation in the nature of "any other business or commercial rights of similar nature". This term is placed in after terms like know-how, patents, copyrights, trademarks, licenses and franchises. Thus the term must be understood in light of the terms placed before it. Further goodwill is an intangible asset and is in the nature of commercial rights and hence, it is covered by this term. The assessee usually rely on the Apex Court decision in the case of *CIT vs. Smifs Securities Ltd.* 252 CTR 233 (SC).

3.6.3.5 Depreciation under Section 32 is allowable on goodwill in the category of intangible assets but not on goodwill acquired through amalgamation. As per Section 32(1) of the Act, 'depreciation' in the case of any block of assets, is to be computed on the written down value. According to *explanation 2 of Section* 32(1) "written down value of the block of assets" shall have the same meaning as in *Section 43 (6)(c)*. This Section lays down the meaning of the term "written down value", as under:

43(6) "written down value" means—

a. *In the case of assets acquired in the previous year, the actual cost to the assessee;*

b. *In the case of assets acquired before the previous year, the actual cost to the assessee less all depreciation actually allowed to him under this Act, or under the Indian Income-tax Act, 1922 (11 of 1922), or any Act repealed by that Act, or under any executive orders issued when the Indian Income-tax Act, 1886 (2 of 1886), was in force:*

Provided that in determining the written down value in respect of buildings, machinery or plant for the purposes of Clause *(ii) of Sub-section (1) of Section 32, "depreciation actually allowed" shall not include depreciation allowed under sub-clauses (a), (b) and (c) of Clause (vi) of Sub-section (2) of Section 10 of the Indian Income-tax Act, 1922 (11 of 1922), where such depreciation was not deductible in determining the written down value for the purposes of the said Clause (vi);*

c. *In the case of any block of assets,—*

i. *In respect of any previous year relevant to the assessment year commencing on the*

1st day of April, 1988, the aggregate of the written down values of all the assets falling within that block of assets at the beginning of the previous year and adjusted,—

A. *By the increase by the actual cost of any asset falling within that block, acquired during the previous year;*

B. *By the reduction of the moneys payable in respect of any asset falling within that block, which is sold or discarded or demolished or destroyed during that previous year together with the amount of the scrap value, if any, so, however, that the amount of such reduction does not exceed the written down value as so increased; and*

C. *In the case of a slump sale, decrease by the actual cost of the asset falling within that block as reduced—*

a. By the amount of depreciation actually allowed to him under this Act or under the corresponding provisions of the Indian Income-tax Act, 1922 (11 of 1922) in respect of any previous year relevant to the assessment year commencing before the 1st day of April, 1988; and

b. *By the amount of depreciation that would have been allowable to the assessee for any assessment year commencing on or after the 1st day of April, 1988 as if the asset was the only asset in the relevant block of assets,*

so, however, that the amount of such decrease does not exceed the written down value;

ii. *In respect of any previous year relevant to the assessment year commencing on or after the 1st day of April, 1989, the written down value of that block of assets in the immediately preceding previous year as reduced by the depreciation actually allowed in respect of that block of assets in relation to the said preceding previous year and as further adjusted by the increase or the reduction referred to in item (i).*

3.6.3.6 Thus, if an asset is acquired during the previous year and it falls in a block of asset (like intangible in this case), then the written down value of that block of asset (to which such acquired asset belongs) would be increased by the actual cost of the asset acquired. The definition of *'actual cost'* is given in *Section 43(1). Explanation 7 of Section 43(1)* reads as below:

Explanation 7.—Where, in a scheme of amalgamation, any capital asset is transferred by the amalgamating company to the amalgamated company and the amalgamated company is an Indian company, the actual cost of the transferred capital asset to the amalgamated company shall be taken to be the same as it would have been if the amalgamating company had continued to hold the capital asset for the purposes of its own business.

3.6.3.7 In the example mentioned earlier, goodwill was created/ transferred by the amalgamating company (PCo) to amalgamated company (SCo). According to this explanation, the 'actual cost' of goodwill to the amalgamated company (SCo) shall be same as it would have been if the amalgamating company (P Co) had continued to hold the capital asset for the purpose of its own business. Since the actual cost of goodwill in the case of amalgamating company (PCo) is zero, the actual cost in the case of amalgamated company (SCo) shall also be zero (and not the amount it paid to acquire the goodwill).

3.6.3.8 This becomes clearer by reference to *Explanation 2* to *Clause 43(6)(c)* which reads as under:

Explanation 2.—Where in any previous year, any block of assets is transferred,—

a. *by a holding company to its subsidiary company or by a subsidiary company to its holding company and the conditions*

of Clause (iv) or, as the case may be, of Clause (v) of Section 47 are satisfied; or

b. *by the amalgamating company to the amalgamated company in a scheme of amalgamation, and the amalgamated company is an Indian company,*

Then, notwithstanding anything contained in Clause (1), the actual cost of the block of assets in the case of the transferee-company or the amalgamated company, as the case may be, shall be the written down value of the block of assets as in the case of the transferor-company or the amalgamating company for the immediately preceding previous year as reduced by the amount of depreciation actually allowed in relation to the said preceding previous year.

3.6.3.9 Thus the Act clearly lay down that the actual cost of the block of asset (intangible block in this case) in the hand of the amalgamated company (SCo) would be written down value in the immediate preceding year in the case of amalgamating company (PCo). Since, the written down value of the intangible block of asset was zero in the books of the amalgamating company (PCo), the actual cost would remain zero in the hand of amalgamated company (SCo). Therefore the cost of goodwill in the hand of amalgamated company (SCo) shall be zero for the purpose of depreciation.

3.6.3.10 Reference can also be made to the 6th proviso (5th proviso before Finance Act 2015) to Section 32(1), which reads as under:

Provided also that the aggregate deduction, in respect of depreciation of buildings, machinery, plant or furniture, being tangible assets or know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets allowable to the predecessor and the successor in the case of succession referred to in Clause (xiii), Clause (xiiib) and Clause (xiv) of Section 47 or Section 170 *or to the amalgamating company and the amalgamated company in the case of amalgamation, or to the demerged company and the resulting company in the case of demerger, as the case may be, shall not exceed in any previous year the deduction calculated at the prescribed rates as if the succession or the amalgamation or the demerger, as the case may be, had not taken place, and such deduction shall be apportioned between the predecessor and the successor, or the amalgamating company and the amalgamated company, or the demerged company and the resulting company, as the case may be, in the ratio of the number of days for which the assets were used by them.*

3.6.3.11 Thus even if the intangible block of asset has some value (which is incorrect as has been explained above that it has zero value) the depreciation under this proviso is to be restricted to the value considering that amalgamation has not taken place. Since in the hand of the amalgamating company the depreciation would have been zero, there cannot be depreciation in the hand of the amalgamated company.

3.6.3.12 This issue has been dealt with and explained elaborately by ITAT Bangalore vide its order dated 30th Sept 2016, in the case of United Breweries Limited in I.T. A. No. 722, 801 & 1065/ Bang/ 2014. The ITAT considered the decision of Hon'ble SC in the case of *CIT vs. Smiff Securities Ltd and held that Hon'ble SC* only ruled on the issue as to whether goodwill falls in the category of intangible assets or any other business or commercial rights of similar nature. Hence, it was held that due to operation of 5th proviso (now 6th proviso) to Section 32(1) of the Act, the depreciation on goodwill to assessee is allowable only to the extent if such amalgamation has not taken place. Thus no depreciation was allowed on the goodwill.

3.6.3.13 The assesses sometimes take the argument that where amalgamation has been approved by the High Court, the effective date of amalgamation and the amalgamation itself cannot be questioned. It is to be noted that only the normal provisions of the Income-tax Act have

to be applied which do not allow depreciation on goodwill acquired during amalgamation. HC order approving merger does not prohibit application of normal provisions of the Act.

4. TAX PERSPECTIVE IN CROSS BORDER MERGERS & ACQUISITIONS

4.1 Tax issues arise in cross border deals when two different jurisdictions seek to tax the same sum of money or income or the same legal person thereby resulting in double-taxation. Cross-border mergers and acquisitions involve transfer of assets and operations of entities belonging to two different countries. Acquisition refers to the purchasing of assets or stocks of part or all of another entity/ entities that result in operational control of the whole or part of the other entity. Generally, cross border merger and acquisition are effected/ happened through transfer of shares having voting power. Under Section 90(2) of the ITA, if the non-resident is resident in a country with which India has a DTAA, he would be taxable according to the provisions of the DTAA or the ITA, whichever is more beneficial to him.

4.2 Relief under the DTAA should normally be available as long as the non-resident is resident and a separate legal person liable to tax under the laws of the relevant country and liable to tax under its laws. Sections 90(4) and 90(5) require a non-resident claiming treaty relief to:

i. Furnish a valid Tax Residency Certificate ("TRC") issued by the government of its home country;

ii. Provide certain additional information, as may be prescribed from time to time, in Form 10F.

4.3 Under Section 195 of the Income-tax Act, any person making a payment of a sum to a non-resident that is chargeable to tax under the Income-tax Act (read with relevant provisions of the applicable DTAA) would be required to withhold tax on such sum at the appropriate rate. Such withholding is required to be made either at the time of payment or at the time of credit of income to the account of the non-resident. However, if the amount paid is not taxable in India, there is no requirement to withhold tax on such payments. However, if the amount paid has an element of income that is taxable in India, then even a non-resident who making such remittance is obligated to withhold as per the Income-tax Act.

4.4 The merger of two foreign companies involving the transfer of shares of an Indian company, is normally tax exempt provided that the merger satisfies the criteria for an Amalgamation mentioned earlier and, (i) at least 25% of the shareholders of the merging company remain shareholders in the merged company, and (ii) such transfer does not attract capital gains tax in the country in which the merging company is incorporated.

The demerger involving the transfer of shares of an Indian company by a demerged foreign company to the resulting foreign company are also tax exempt provided that (i) the shareholders holding not less than 3/4 of the shares in the demerged foreign company remain shareholders in the resulting company and (ii) such transfer does not attract capital gains in the country in which the demerged foreign company is located. The merger of an Indian company with a foreign company is also tax exempt, provided the resulting company is an Indian company.

4.5 Through the Finance Act, 2012, the Parliament had introduced "indirect transfer provisions" with retrospective effect as a clarification of the intent of the Legislature. Where a foreign company transfers shares of a foreign company to another company and the value of the shares is derived substantially from assets situated in India, then capital gains derived on the transfer are subject to Income-tax in India. Further, payment for such shares is subject to Indian Withholding Tax (WHT). Shares of a foreign company are deemed to derive their

value substantially from assets in India if the value of such Indian assets is at least Rs 10 crores and represents at least 50 Per cent of the value of all the assets owned by such foreign company. Rules are notified for computing the FMV and consequent gains attributed to assets located in India. The value of assets, both tangible and intangible, is deemed to be their FMV on the 'specified date' without reduction of liabilities (if any) for the asset. The rules also require the Indian entity and the transferor entities to report the information in prescribed forms. Explanation 7 to Section 9(1)(i) provides exemption under certain conditions.

4.6 Thus provisions require that gains arising from the transfer of shares of a company incorporated outside India would be taxable in India if such shares substantially derive their value from assets located in India. The provisions were introduced after the Supreme Court's decision in the *Vodafone International Holdings B.V. vs. Union of India & Ors.* ((2012) 341 ITR 1 (SC)*)* which held that such transactions are not taxable in India. In this case Vodafone International Holdings B.V. had not made withholding tax, despite the order of the Assessing Officer to do so, in respect of purchase of shares of another foreign company which indirectly controlled the Indian Company, thereby gaining control of the Indian Company.

4.7 Delhi High Court in the case of *DIT vs. Copal Research Mauritius Limited, Moody's Analytics, USA & Ors.* (2015) 371 ITR 114 (Delhi) stated that the term "substantially" as used in explanation 5 to Section 9(1)(i) should be interpreted to mean "principally", "mainly" or at least "majority". Consequently, it concluded that the indirect transfer tax provisions shall apply when the overseas company derives at least 50% of its value from Indian assets. *Despite these amendments, the question is often raised, and Courts do allow, that if the provisions of the DTAA does not allow taxation rights to India, then DTAA provision will override the domestic legislation.* Refer Sanofi Pasteur Holdings *SA vs. The Department of Revenue* 354 ITR 316 (AP), GEA Refrigeration Technologies GMBH, In re (2018) 401 ITR 0115 (AAR). Hence it is also important to consider the relevant DTAA, if applicable to the transferor company.

4.8 Vide Notification dated 20/03/2018, the Reserve Bank has made FEM (Cross Border Merger) Regulation, 2018 relating to merger, amalgamation and arrangement between Indian companies and foreign companies under the Foreign Exchange Management Act, 1999. In the cross border merger and acquisition, DTAA and arm's length pricing of the transactions are two important ingredients, which is discussed as under:

A. Tax Treaty Consideration

The Central Board of Direct Taxes issued Circular No. 789 in 2000, which provides that a certificate of residence issued by the Mauritius Government to a Mauritius Company was sufficient for the Mauritius company to establish residence and beneficial ownership under the India-Mauritius tax treaty. The companies incorporated in Mauritius were liable to tax under the laws of Mauritius and therefore, were deemed to be residents of Mauritius for the purposes of the treaty. Accordingly, such companies would not be taxable in India on income from capital gains. The Delhi High Court has quashed this circular as violative of the Income-tax Act but the Supreme Court upheld its validity as a device of legitimate tax planning. The validity of this circular was upheld by the Supreme Court in *Azadi Bachao Andolan vs. Union of India* (2003) 132 Taxmann 373 (SC). However, the Supreme Court's reasoning in *Azadi Bachao Andolan Case* was not held to be applicable in 14 July 2011 decision of the Bombay High Court in the *Aditya Birla Nuvo Ltd. vs. Deputy Director of Income-tax (IT)* (2012) 342 ITR 308 (Bombay). The High Court agreed with the Indian tax authorities and concluded that the sale of shares of an Indian company by a Mauritius company is taxable in India because AT&T Mauritius was not the beneficial owner of the

shares that were sold but rather was a permitted transferee of its US parent-company under the JVA (Joint Venture Agreement). In arriving at this conclusion, the High Court observed that, although the shares of Idea Cellular Ltd. (ICL) were allotted to AT&T Mauritius (the seller), all rights in respect of the shares vested in AT&T USA. Consequently, AT&T Mauritius is not the beneficial or real owner of the shares but only a permitted transferee. As AT&T USA is the real owner of the shares of ICL, hence benefit of India-Mauritius DTAA is not applicable in the given case. Hence, income earned by AT&T Mauritius on sale of shares of ICL is in substance income of AT&T USA and hence would be subject to tax in India. To sum up, we can say that in certain cases the courts and revenue authorities have allowed the assessee to take benefits of India-Mauritius DTAA and in certain cases, they have lifted the corporate veil so as to find out who is the beneficial owner of these shares. This has created a lot of uncertainty in Indian cross-border M&A. Recent amendments to the Income-tax Act, aiming to restrict the benefit of DTAA to legitimate tax residents of foreign countries have now made it mandatory to obtain a Tax Residency Certificate ('TRC') in the prescribed form from the Government of the foreign country or territory for the purposes of seeking any relief or benefit under applicable DTAA. However, while the amendments make the obtaining of a TRC mandatory, it has been clarified that a TRC only will not be sufficient to successfully claim any relief or benefit under a DTAA. The memorandum explaining the above provisions or amendments have been made by the Finance Act, 2012 to recognize the concept of "substance" over "form". However, it is feared that the same may lead to huge litigation and will raise substantial questions over validity of decision of Hon'ble Supreme Court in *Azadi Bachao Andolan Case* (2003) 132 Taxmann 373 (SC).

B. Transfer Pricing Considerations

According to law, all cross-border deals between group companies need to be at arm's length, that is, as if it was with an unrelated company. Transfer pricing by itself does not necessarily involve tax avoidance. It is where the pricing do not accord with applicable norms internationally like the arms length's principles, or at domestic law that is the issue of tax avoidance and evasion arise.

5. CHECK LIST FOR ASSESSING OFFICERS

There are several provisions under the Income-tax Act which allow the restructuring of the bona fide businesses without having any tax incidence. However, there are several safeguards which prevent the misuse of such provisions. The above spirit makes it all the more important for the AO to ensure that the provisions relating restricting are complied to and not misused with the sole aim of bringing down the tax liability.

5.1 Before the Amalgamation/ Merger/ Demerger/ Reconstruction

1. The Scheme of amalgamation/ merger/ de-merger/ reconstruction/ rearrangement of the companies is to be presented to National Company Law Tribunal (NCLT) by the said companies along with copy to Assessing Officer of the Income-tax Department.
2. The notice to Income-tax Authorities is required to be issued under Section 230 (5) or other relevant Sections of the Companies Act 2013 by the NCLT.
3. As per General Circular No. 1/2014 dated 15/01/2014 of Ministry of Corporate Affairs, the MCA has directed to the concerned authorities to obtain the objections/ comments from the Income-tax Department.

4. As per the letter of CBDT F. No. 279/ Misc/ M-171/2013-ITJ dated 11/04/2014, the Assessing Officers are directed to furnish the comments and inputs invariably so as to ensure that the proposed scheme of reconstruction/ amalgamation/ demerger has not been designed in such a way as to defraud the revenue.
5. Check whether any particular shareholder or shareholder group has benefited without paying any Capital Gains tax under the guise of the scheme of amalgamation or demerger.
6. Accordingly, the AO's after studying the scheme of amalgamation/ merger/ demerger and receiving the notice from NCLT/ High Court should invariably submit the detailed comments through Pr. CIT.
7. The Department/ AO should submit the specific comments within 15 days of receipt of notice from the concerned authorities, failure to submit the comments is deemed to be considered as no objection from the department.
8. As per letter of CBDT F. No. 278/ M-52/ 2003-ITJ(Pt.), dated 08/11/2017, it was directed to the AO's that the representations should be submitted before the benches of NCLT created under new 'Insolvency and Bankruptcy Code 2016'.
9. If the AO is able to establish before the NCLT that one of the purposes of amalgamating two or more companies or demerger of undertaking is to avoid payment of due taxes then there are instances where the assessee withdrew the petition of amalgamation/ demerger scheme [Mumbai Cargo Services Centre Airport Private Limited (CP(CAA)/2878/ MB/2018)]. In other instances it is observed that the NCLT allowed the scheme of amalgamation/ demerger with a rider that the Income-tax Department is free to examine the taxability of the transactions in consequence of the approval of the scheme.
10. There are also instances where the Hon'ble High Court refused to sanction the scheme of amalgamation after it was held that the object of the scheme of amalgamation was only to avoid the tax liability on transfer of assets. This principle was enunciated by Gujarat High Court in *Wood Polymer Ltd. vs. IN RE* (1977) 109 ITR 177 wherein the only purpose for the merger was to avoid capital gains tax through transfer of an asset to a paper company which was later intended to be merged with the transferee company.

5.2 After the Amalgamation/ Merger/ Demerger/ Reconstruction

1. Collect all the records of all the amalgamating companies (transferor companies)/ demerged company by the AO of the amalgamated company (transferee company)/ resulting company.
2. Get all the PAN of the amalgamating companies (transferor companies)/ demerged company migrated to the AO of the amalgamated company (transferee company)/ resulting company.
3. Merge all the PAN of the amalgamating companies (transferor companies)/ demerged company with the PAN of the amalgamated company (transferee company)/ resulting company.
4. All notices for proceedings pending in amalgamating companies (transferor companies) issued earlier in the name of amalgamating companies become *ab-initio void* after the record date and have to be re-issued in the name of the amalgamated company (transferee company) only.
5. Ensure that all the notices after the Appointed Date even relating to matters prior to the Appointed Date in respect

of amalgamating companies (transferor companies) are issued in the name of the amalgamated company (transferee company) only.

6. Ensure that all the conditions laid down in the Act for amalgamation Section 2(1B), demerger Section 2(19AA) and slump sale (Section 50B) are complied with. In case of any violation of any condition, the benefits of non-taxability on transfer of assets; carry forward of loss & unabsorbed depreciation, deduction, exemption, etc. shall not be available to the amalgamated company (transferee company) or resulting company or demerged company or their shareholders.

7. Examine the applicability of provisions of GAAR and invoke the provisions accordingly.

8. *The AO has to ensure that statutory notices and assessment order have to be made in the name of the amalgamated company (transferee company) and not in the name of amalgamating company (transferor company).* Courts have held that failure to do so make the assessment order null and void. This is particularly important since approval of amalgamation/ merger is often with retrospective effect. Hence, the Assessing Officer must invariably ascertain if there has been any amalgamation/ merger before issuing any notice(s) pertaining to the assessment. In the case of *Spice Entertainment Ltd. vs. CIT* Reported in 247 CTR 500 (Del), it was held that if the assessment is concluded in favour of a non-existing entity, then notwithstanding Section 292B of the Act, the position does not improve. (The Hon'ble Supreme Court has dismissed SLP vide order dated 02/11/2017 in CA No. 285 of 2014). The Hon'ble Delhi High Court in *CIT vs. Dimension Apparels Pvt. Ltd.* (2015) *reported in* 370 ITR 288 has also held that the framing of assessment against a non-existing entity/ person is a jurisdictional defect. However, under a particular set of facts Hon'ble Supreme Court in case of *Skylight Hospitality LLP vs. ACIT* (2018-TIOL-125-SC-IT) has held that wrong name given in the notice was merely clerical error which could be corrected under Section 292B of the Income-tax Act, 1961. However in a recent decision in the case of *Pr. CIT vs. Maruti Suzuki Ltd.* reported in (2019) 309 CTR (SC) 433, the Apex Court has settled that assessment in the name of amalgamating company is void *ab initio*.

9. Similarly in case of private limited companies with brought forward losses, change in shareholding should invariably be ascertained.

6. SAMPLE QUESTIONNAIRE FOR THE ASSESSING OFFICER

6.1 In the Case of Amalgamation, the AO may Ask Following Questions

1. Please give point-wise reply as to how each condition of Section 2(1B) of the Act is satisfied.

2. Please furnish the details of the shareholding pattern of the amalgamating company before the amalgamation and of the amalgamated company immediately after the amalgamation.

3. Please state whether the depreciation claimed on assets acquired under amalgamation exceeds the deduction which would have been allowed to the Transferor Company, had the amalgamation not taken place. Also furnish the calculation of the depreciation on assets acquired under amalgamation.

4. Please furnish the complete details of carry forward of losses and unabsorbed depreciation pertaining to amalgamating

company and set-off of these losses and/ or unabsorbed depreciation in the current year in the hands of the amalgamated company.

5. Please state whether any carry forward of loss under the head 'house property' or 'capital gain' of the transferor company is being carried forward or set off against the house property income or capital gain respectively of the transferee company. If yes, then please furnish the complete details thereof.

6.2 In the case of Demerger, the AO may ask following questions:

1. Please give point-wise reply as to how each condition of Section 2(19AA) of the Act is satisfied.
2. Please state as to how the conditions relating to definition of 'undertaking' as per Explanation 1 is satisfied.
3. Please furnish the complete activities during last five years of the undertaking to justify that it was involved in the business activity and the transfer of the undertaking was on a going concern basis.
4. Please furnish the complete details of all assets and liabilities of the undertaking.
5. Please furnish the book value of assets and liabilities and state whether there is any difference between the value of assets and liabilities appearing in the books of account of demerged company immediately before the demerger and in the books of account of the resulting company immediately after the demerger i.e. on the appointed date.
6. Please state whether there is any difference between the consideration of the demerger and the value of assets and liabilities appearing in the books of account of demerged company immediately before the demerger.
7. Please furnish the details of the shareholding pattern of the demerged company and resulting company before and after appointed date.
8. Please furnish the valuation report, if any, for determining the FMV of the shares of the resulting company, if the shares are not issued at face value.
9. Please state whether the depreciation claimed on assets acquired under demerger exceeds the deduction which would have been allowed to the demerged company, had the demerger not taken place. Also furnish the calculation of the depreciation on assets acquired under demerger.
10. Please furnish the complete details of carry forward of losses and unabsorbed depreciation pertaining to demerged undertaking and set-off of these losses and/ or unabsorbed depreciation in the current year in the hands of the resulting company.
11. Please state whether any carry forward of loss under the head 'House Property' or 'Capital Gain' of the demerged undertaking is being carried forward or set off against the house property income or capital gain respectively of the resulting company. If yes, then please furnish the complete details thereof.

6.3 In the case of Slump Sale, the AO may ask following questions:

1. Please state as to how the conditions relating to definition of 'undertaking' as per Explanation 1 to Section 2(19AA) is satisfied.
2. Please give the date of acquisition and date of transfer of each of the undertakings to ascertain period of holding.
3. Please furnish the complete details of all assets and liabilities of the undertaking.

7. ILLUSTRATIVE CASES FOR ASSESSING OFFICERS

Example 1 (Depreciation on Goodwill):

1. Company A bought all the shares of Company B from the shareholders of Company B for Rs. 267,63,35,393/- resulting that Company B becomes subsidiary of Company A. The net book value of all assets of Company B was Rs. 22,36,67,034/-.
2. Then Company A and Company B amalgamated.
3. Since the price paid for purchase of Company B was Rs. 245,26,68,359/- (Rs. 267,63,35,393 *less* Rs. 22,36,67,034) more than the net book value of all assets of Company B, the Company A claimed payment of Rs. 245,26,68,359/- for Goodwill on which depreciation was claimed.
4. As per the 6th proviso of Section 32(1) of the Act, the depreciation on Goodwill is not allowable and deduction for depreciation shall not exceed in any previous year as if the amalgamation had not taken place. It means the Company A shall be entitled for depreciation on assets of Rs. 22,36,67,034/- only.

Example 2 (Inflation of Closing Stock by Changing Valuation Method):

1. Company A and B were amalgamated in Company C.
2. The closing stock in the hands of Company A and B just prior to amalgamation was revalued by changing the method of valuation of the stock from FIFO to LIFO (or LIFO to FIFO as the case may be) which was in departure with the normal method followed in the earlier years. Such change in method of valuation resulted into inflation in value of closing stock of Company A and B.
3. Inflation of closing stock of Company A and B meant that the opening stock of Company C was also inflated.
4. The net effect of changing the method of valuation of closing stock was to reduce the profits of the Company C to the extent of inflated value of the stock.

Example 3 (Double Claim of Refund):

1. Companies A, B, C, D & E had filed their returns of Income on the due dates. Their returns were processed and refunds totaling Rs. 113 crores were granted.
2. The Appointed date set by the High court was prior to the year in which these refunds were claimed.
3. Post Amalgamation, the amalgamated company (transferee company) F filed a return for the same year and claimed refund of Rs. 113 crores.
4. This brought to light that the claim of the same 113 crores of refund was being made by F though the same had been received by the amalgamating Companies A,B,C, D&E

Example 4 (Transfer of Business at Higher Value without any CG tax):

1. Company A filed an application before the Hon'ble NCLT for approval of scheme of arrangement for demerger of an undertaking of Company A into Company B.
2. It was observed from the scheme of demerger that the assets of Rs. 1.72 crores of the undertaking was proposed to be demerged from Company A to Company B for a consideration of Rs. 76.00 Crores in the form of equities of Company B and proposed to create goodwill of Rs. 74.28 crores in the hands of Company B.
3. A report was furnished before the NCLT by AO stating that the arrangement is not tax neutral and doesn't fulfill the conditions of Section 2(19AA)(iii) of the Act i.e. the

conditions relating to transfer of property and liability at book value.

4. Since the conditions for demerger was not fulfilled, the transfer of assets under the demerger scheme would not get exemptions from the capital gain tax and the transaction was to be treated as 'Transfer'. Accordingly, the Department claimed before the NCLT a potential capital gain tax liability on STCG of Rs.74.28 crore (Rs.76.00 crore *less* Rs.1.72 crore). The department also claimed DDT on Rs.74.28 crore from the demerged company (Company A) as the consideration for the said 'Transfer' was proposed to be received by the shareholders of Company A directly from the Company B. It was also claimed by the Department that the shareholders of Company A, being two individuals, are also liable to pay tax @ 10% on dividend received i.e. Rs.74.08 crore (Rs.74.28 crore *less* 0.20 crore) as per Section 115BBDA of the Act.
5. After considering the above claim of the Department and non-willingness for payment of above tax by the petitioner, the NCLT dismissed the Scheme of Demerger.

Example 5 (Transfer of Shares without Paying CG Tax):

1. The Company A transferred its investment in equities of related concerns having book value of Rs. 774.10 Crores to a newly incorporated company B for a consideration of 10,10,003 equity shares having face value of Rs. 10 each of Company B under a Scheme of Demerger. In other words, the Company A received shares worth Rs. 1,01,00,030/- against the transfer of the said investment of Rs. 774.10 crore.
2. During the assessment of Company A, it was found that the said investment in equities of related concerns was transferred at lower value than the book value under a Scheme of Demerger. After examining the submissions of the assessee, memorandum to Finance Bill, 1999 and provisions of Section 2(19AA) of the Act, the assessee's claim of benefit of tax exemption on transfer of the said investment as per the Scheme of Demerger was denied stating that (i) investment in equities of the related concerns was not a business activity as per explanation 1 below to Section 2(19AA) and (ii) the said investments were not transferred at book value appearing in Company A's books of account immediately before the demerger thereby not fulfilling the conditions of Section 2(19AA)(iii) of the Act.
3. Further, Company A reduced its reserve and surplus by Rs. 599.58 crores and also claimed the remaining balance in the form of loss of Rs. 173.52 crores in the Profit & Loss Account.
4. Since the transaction was treated as transfer of assets, the valuation of equity shares as per Rule 11UA of the I.T. Rules was done and difference between the valuation and book value was treated as Capital Gain under Section 50D of the Act.

Example 6

1. A Company 'A' has paid-up share capital of Rs. 100 with each share having face value of Re 1. It has four shareholders namely, A1, A2, A3 and C with 25 shares each. On the asset side, the Company has land of Rs. 100/- however, the intrinsic value of land is much higher at Rs. 1,000/-.
2. Another Company 'B' has paid-up share capital of Rs. 100 with each share having face value of Rs. 1. It has four shareholders namely, A1, A2, A3 and D with 25 shares each. On the asset side, the company has bank balance of Rs. 100/-.
3. Company 'A' amalgamates with Company 'B' and swap ratio being 1:1, each shareholder of Company 'A' gets 25 shares

B/S of 'A'		B/S of 'B' (Pre-amalgamation)	
Liability	Asset	Liability	Asset
A1 – 25 A2 – 25 A3 – 25 C – 25	Land – 100	A1 – 25 A2 – 25 A3 – 25 D – 25	Bank – 100
100	100	100	100

B/S of 'B' (Post-amalgamation)	
Liability	Asset
A1 – 50 A2 – 50 A3 – 50 C – 25 D – 25	Land – 100 Bank – 100
200	200

of Company 'B'. The Balance Sheets of the companies at pre-amalgamation and post-amalgamation stages are as below:

4. Thus, the amalgamation resulted in allotment of 25 shares to 'D' in the amalgamated company which now owns land (which has intrinsic value of Rs. 1,000 compared to the book value of Rs. 100). Further, 'C' which had 1/4th share in land pre-amalgamation, has only 1/8th share post-amalgamation. However, 'D' now has 1/8th share in land. In other words, a portion of land share shifted from 'D' to 'C'.

5. Although there is no change in share of 'C' and 'D' post-amalgamation as per the book value of the assets, there is substantial change in their shares if the Fair Value of the asset is taken. As per FMV, the value of D's share increased from Rs. 25 to Rs. 137.50 and value of C's share reduced to Rs. 137.50 from Rs. 250 due to the amalgamation.

6. Issues for consideration before the AO:

   i. All conditions of amalgamation as per Section 2(1B) of the Income-tax Act, 1961 is satisfied yet a question arises whether the Scheme of Amalgamation is tax neutral.

   ii. Can the transfer of asset from 'C' to 'D', without payment of any tax, may be taken before the NCLT as one of the arguments for showing that the amalgamation is a colourable device for transfer of asset from 'C' to 'D' ?

   iii. Can the provisions of Income-tax Act relating to GAAR may be invoked?

Example 7

1. A Company 'A' has paid-up share capital of Rs. 200 with each share having face value of Rs. 1. It has four shareholders namely, A1, A2, A3 and A4 with 50 shares each. On the asset side, the Company has land of Rs. 100/- however, the intrinsic value of land is much higher at Rs. 1,000/-. It also has asset of Rs.100/- in the form of bank balance.

2. Another Company 'B' has paid-up share capital of Rs. 100 with each share having face value of Rs. 1. It has two shareholders namely, X and Y with 50 shares each. On the asset side, the company has bank balance of Rs. 100/-.

3. It is assumed that 'land' of Company 'A' satisfies the definition of 'Undertaking' as per Explanation 1 to Section 2(19AA) of the Act. By a Scheme of Demerger, the undertaking relating to 'land' demerges to the resulting company 'B'. Thus, Company 'A' is demerged company and Company 'B' is resulting company while the 'land' represents 'undertaking'.

4. The NAV of each share of 'A' and 'B', before demerger, is Re 1 based on Book value of the asset. On demerger, each shareholder of company 'A' will receive 25 shares of company 'B'. The Balance Sheets of the companies at pre-demerger and post-demerger stages are as below:

B/S of 'A' (Pre-demerger)		B/S of 'B' (Pre-demerger)	
Liability A1 – 50 A2 – 50 A3 – 50 A4 – 50	Asset Land – 100 Bank – 100	Liability X – 50 Y – 50	Asset Bank – 100
200	200	100	100

B/S of 'B' (Post-demerger)	
Liability X – 50 Y – 50 A1 – 25 A2 – 25 A3 – 25 A4 – 25	Asset Land – 100 Bank – 100
200	200

5. Thus, the demerger resulted in increase in intrinsic value of shares of 'X' and 'Y'. Prior to demerger the FMV of their shares was Rs. 50 each but after demerger it increased to Rs.275 each (because the FMV of land is Rs. 1000 against the book value of Rs. 100). Similarly, the intrinsic value of shares of A1, A2, A3 and A4 was Rs. 275 prior to demerger which reduced to Rs. 162. 50 each (Rs. 137.50 in Company 'B' and Rs. 25 in Company 'A') post-demerger.
6. It can be said that demerger resulted in transfer of assets from A1, A2, A3 and A4 to 'X' and 'Y' in real value term.
7. Issues for consideration before the AO:
   i. All conditions of demerger as per Section 2(19AA) of the Income-tax Act, 1961 is satisfied yet a question arises whether the Scheme of demerger is tax neutral.
   ii. An the transfer of asset from A1, A2, A3 and A4 to 'X' and 'Y' without payment of any tax, may be taken before the NCLT as one of the arguments for showing that the demerger is a colourable device for transfer of asset to 'X' and 'Y' ?
   iii. Can the provisions of Income-tax Act relating to GAAR be invoked?

8. GENERAL ANTI-AVOIDANCE RULE (GAAR) AND M&A

8.1 Tax evasion is unlawful and is result of illegality, mis-representation and fraud and is not allowed. Tax avoidance is the outcome of actions taken by the tax payer, none of which is illegal or forbidden by the law. It is an arrangement entered into solely or primarily for the purpose of obtaining a tax advantage. Tax avoidance through artificial structures is economically undesirable and hence GAAR is

enacted to check tax avoidance. It is a set of rules that empower the tax authority of any country to investigate and examine the transactions done with the objectives of tax avoidance. GAAR is an anti-avoidance measure which empowers tax authorities to call a business arrangement or a transaction 'impermissible avoidance arrangement' and thereby denying tax benefits to the parties. In

8.2 In India, till recently Specific Anti Avoidance Rule 'SAAR' was in vogue i.e. laws were amended to plug specific loopholes as and when they were noticed. But no one can predict the future. Similarly no law can anticipate all the circumstances. That's why GAAR was enacted. GAAR is based on the doctrine of 'substance over form' which means that the tax authorities ignore the legal form of an arrangement and they look into its actual substance to prevent artificial structures from being used for tax avoidance purposes. GAAR is a concept which generally empowers the revenue authorities in a country to deny the tax benefits of transactions or arrangements which do not have any commercial substance or consideration other than achieving the tax benefit.

8.3 The GAAR was introduced by the Finance Act, 2012 by insertion of chapter X-A (consisting of Sections 95 to 102) in the Income-tax Act. The procedural provisions relating to mechanism for invocation of GAAR and passing of the assessment order inconsequence thereof are contained in Section 144BA. These provisions permit the authorities to disregard in assessing a taxpayer's liability any agreement, structure or device employed not for bona fide commercial reasons but rather 'to obtain, directly or indirectly, a tax benefit'. *The provisions of the GAAR are applicable from 01/04/2017 i.e. AY 2018–19.* The main premise of invoking GAAR is that any transaction or step in a transaction which has its main purposes i.e. the obtaining of a tax benefit, should be disregarded, or dealt with in such a manner so as to protect the right of the revenue to taxes. An impermissible avoidance arrangement means an arrangement, the main purpose of which is to obtain a tax benefit and it:

1. Creates rights and obligations which are not normally created between persons dealing at arm's length; or
2. Result directly or indirectly in the misuse of the provisions of the Act; or
3. Lack commercial substance in whole or in part; or
4. Be entered into or carried out, by means or in such a manner which are not ordinarily employed for bona fide purposes.

If a transaction is regarded as an avoidance transaction, it could be disregarded, combined with any other step in the transaction or re-characterized, or the parties to the transaction could be disregarded as separate persons and treated as one. The provisions are drafted in a manner to permit the application of principles relating to lifting of corporate veil, substance over form test, economic substance test and thin capitalization rules such as re-characterization of debt into equity or vice-versa.

8.4 The provisions relating to GAAR is relevant for the business restructuring also. In a recent case before the NCLT, the GAAR was cited as one of the reasons for dismissing the Scheme of Amalgamation and it was held that the Amalgamation is not in the public interest. The case is discussed briefly below:

1. In the case of *Scheme of Amalgamation between M/s. Ajanta Pharma Limited (APL),* a listed company, and M/s. Gabs Investment Private Limited (GIPL), a private limited investment company, the entire shareholding of GIPL was held by Agrawal Family Members *(Promoters)* and both GIPL and Agrawal Family Members were shareholders and promoters of APL.
2. In the Scheme of Amalgamation, GIPL was proposed to be merged into AJL. Pursuant to the acceptance of the proposed Scheme,

individual Promoters would have received proportionate shares in AJL.

3. The Department raised objections alleging that the Scheme was a deliberate measure to avoid a tax burden by using the via-media of NCLT, and that it was nothing but round-trip financing, which included a transfer of funds among the parties to the arrangements through a series of transactions.

4. The Department argued that GIL being a private limited company has to be considered as a separate entity from its Promoter shareholders and, thus, any "assets" of GIPL cannot be repatriated to the shareholders without incurring tax costs. If assets were to be distributed to the Promoters as dividends, then such income would be subject to Dividend Distribution Tax (DDT) @ 20% in the hands of GIPL.

5. The Department also argued that if the "assets" are distributed to the Promoters by way of sale of shares, then since GIPL is in the business of investments and dealing in equity shares, once the equity shares are sold in the market, it would earn business profit. On that business profit, Income-tax @ 30% under the normal provisions of the Income-tax or Minimum Alternate Tax **(**MAT**)** @ 20% under Section 115JB would be payable by GIPL.

6. The Income-tax Department thus submitted that if the Scheme were approved, it would lead to a loss of more than INR 400 crores to the Revenue. It was also contended that in view of the GAAR, the Scheme should be construed as an Impermissible Avoidance Agreement **(**IAA**)** and, thus, should not be allowed by the NCLT.

7. After examining the rationale of the Scheme, the NCLT held that the Scheme was unjustified, as the Promoters would directly hold shares of the AJL and would effectively continue to hold the same percentage of shares pre and post amalgamation. Based on the fact pattern, it further observed that the Scheme would only benefit and allow unfair advantage to the common promoters of both transferor and transferee companies and was devised only to benefit them without serving any public interest.

8. In view of the objections raised by the IT Authorities about potential tax benefit, tax avoidance and tax loss including GAAR, the NCLT rejected the Scheme.

9. INSOLVENCY AND BANKRUPTCY CODE, 2016

As per the recent circulars and notifications, the amalgamation/ merger/ restructuring of the companies require the NOC of the Income-tax Department mandatorily. Section 281 of the Income-tax Act, 1961, requires a taxpayer to obtain permission of the Assessing Officer prior to creating a charge on or transfer of specified assets. Even the transfer of the stressed assets would require prior permission from the Assessing Officer.

Any scheme of amalgamation/ merger/ de-merger arrangements is to be presented to the NCLT and the specific comments from the Income-tax Department is to be called for before approving the scheme/ arrangement. The report regarding any objections is to be submitted within 30 days from the receipt of the notice from NCLT/ Assessee.

Section 79 of the Income-tax Act provides that carry forward and set off of losses in a closely held company shall be allowed only if there is a continuity in the beneficial owner of the shares carrying not less than 51 Per cent of the voting power, on the last day of the year or years in which the loss was incurred. In general, the case of a company seeking insolvency resolution under Insolvency and Bankruptcy Code, 2016, involves change in the beneficial owners of shares beyond the permissible limit under

Section 79. This acts as a hurdle for restructuring and rehabilitation of such companies. In order to address this problem, relaxation from the rigors of Section 79 in case of such companies has been granted w.e.f. 01/04/2018 if the jurisdictional Pr. CIT or CIT is satisfied. Accordingly, it will apply in relation to Assessment Year 2018–19 and subsequent assessment years. Section 140 of the Income-tax Act, 1961 was amended w.e.f. 01/04/2018 to provide that during the resolution process under the Insolvency and Bankruptcy Code 2016, the return shall be verified by an insolvency professional appointed by the Adjudicating Authority under the Insolvency and Bankruptcy Code, 2016.

10. MECHANISM OF AVOIDANCE OF BUY BACK TAX BY METHOD OF CAPITAL REDUCTION—AMENDMENT PLUGGED THE LOOPHOLE

10.1 Finance Act 2013 introduced buyback tax under Section 115QA as several multinational were using buyback to avoid Dividend Distribution Tax. They also claimed exemption from capital gains tax under DTAA as their parents was based in Mauritius, Singapore or Cyprus.

10.2 To bypass Buyback Tax MNC's scaled–up cost of shares by having a group company buy shares from the parent at a higher cost. Thereby buyback tax was minimized as it applies on the difference between amount of buyback and cost of acquisition of those shares.

Explanation (ii) in Section 115QA: "distributed income" means the consideration paid by the company on buy-back of shares as reduced by (the amount, which was received by the company for issue of such shares, determined in the manner as may be prescribed).

10.3 To counter this scheme Finance Act 2016 brought an amendment to Section 115QA, to prevent avoidance of buy-back tax by scaling up of consideration under tax neutral business reorganization followed by buyback of shares *viz.*

The relevant Clause under Rule 40BB reads:

> *(5) where the share has been issued by a company being as amalgamated company, under a scheme of amalgamation, in lieu of the shares of an amalgamating company, then, the amount received by the amalgamating company in respect of such share or shares determined in accordance with this rule, shall be deemed to be the amount received by the amalgamated company in respect of the share so issued by it.*

10.4 While this rule prevents tax avoidance by scaling up the attribution cost by amalgamation, tax can even now be avoided by and the rules can be BYPASSED by using the LOOPHOLE of capital reduction as the Section covers only buyback of shares.

10.5 If the amalgamating MNC company does a capital reduction and repatriates money to its parents outside India it will not have to pay buy-back tax, as capital reduction is not same as buy-back and Section 115QA covers only buy-back of shares. Capital reduction and buy-back are under different Sections of the Companies Act and process is different. Capital reduction requires Court/ NCL approval which buyback does not etc. Eminent advocates including some who have worked for the government have issued detailed opinions supporting this position. By using this method companies, which have their parent, incorporated in Singapore, Mauritius or Cyprus can avoid both buy-back tax and Capital Gains tax.

10.6 The reason why Capital reduction has not been covered by Section 115QA so far is on the assumption that it will be taxed under Section 2(22)(d) which reads as follows:

> *"Any distribution to its shareholders by a company on the reduction of its capital to the extent to which the company possesses accumulated profits which arose after the end of the previous year ending next before the 1st day of April, 1933, whether such accumulated profits have been capitalized or not;"*

10.7 The condition is 'to the extent to which the company possesses accumulated profits'. To bypass this MNC's do a sham merger whereby a very large cash surplus company is merged into a much smaller company, giving contrived reasons. The smaller company issues shares to acquire the much larger company. Since the valuation is as prescribed by rules it will be much higher than net book value. The difference between book value and valuation for which shares are issued is booked as a negative capital reserve. This is per existing Ind AS 103 and reinforced by Court or National Company Law Tribunal approval of scheme of accounting. The total reserves of the merged company are then converted by merger accounting to share capital and the reserves are reduced to nil. (or negative). Thereafter, the merged company will do a large capital reduction. Since there is some time between the merger and capital reduction, the company would have accumulated some profits. It will pay dividend distribution tax on deemed dividend under Section 2(22)(e) on these but the large reserves before merger will not come under Section 2(22)(d) or 115QA. Neither buyback tax nor Capital gains tax is paid due DTAA exemption for CGT. Even if the company does not have enough cash or reserves to pay back entire value of share capital in a single year (fair value not book value) it can do this the next year and it will only have to pay dividend tax on profits after merger but the pre-amalgamation reserves will not suffer any tax. To plug such loophole, the Finance Act 2018 w.e.f. 01/04/2018 has inserted an Explanation 2A to widen the scope of the term accumulated profits to include accumulated profits of the amalgamating company on the date of amalgamation.

ANNEXURE–A

A Comparison of Different Modes of Acquisition/ Transfer of Assets/ Business

	Slump Sale	Share Sale	Asset Sale	Amalgamation	Demerger
Definition	Transfer of an undertaking/ business for a lump sum consideration on a going concern basis without values being assigned to the individual assets and liabilities in such sale.	Acquisition in whole or part of the shareholding of a company from the existing shareholders. Unless specifically agreed to, the seller has no continuing interest in, or obligation with respect to, the assets, liabilities or operations of the business	The sale of the whole or part of the assets of the target to the acquirer with individual values assigned for each asset.	Merging of one company into another company or merging of two or more companies to form a new company under a court approved process in compliance with Section 391 to 394 of the Companies Act, 1956.	Transfer of undertaking of company to another company under a court approved process in compliance with Section 391 to 394 of the Companies Act, 1956.
Court Approvals	Not Required	Not Required	Not Required	Required	Required
Transfer	All Assets + Liabilities pertaining to the undertaking	All Assets + Liabilities pertaining to the company	Such assets/ liabilities that the parties may determine	All Assets + Liabilities of the Amalgamating Company	All Assets + Liabilities relatable to the undertaking being transferred
Capital Gains	Capital gains realized on the transfer of the undertaking, if held for: more than 36 months, are taxed as long term capital gains. if held for less than 36 months are taxed as short term capital gains. For the purpose of computing capital gains, the cost of acquisition would be the 'net worth' of the undertaking on the date of the transfer (Section 50B of the ITA)	Capital gains realized on the transfer of listed shares, if held for more than 12 months is taxed as long term capital gains. Capital gains realized on the transfer of the shares, if held for 12 months or less is taxed as short term capital gains. As per the Finance Act, 2016, the holding period for unlisted shares has been reduced from 36 months to 24 months.	In case of depreciable assets, capital gains computed on a block of asset basis and the value over and above the aggregate of the written down value of the block of assets and expenditure incurred in relation to the transfer will be treated as the capital gains and subject to tax as short term capital gains. In other cases, capital gains tax payable by the seller will depend on the period that the seller has held each of the assets that are transferred.	No capital gains tax liability if it is a tax neutral amalgamation, and if the transaction is covered under Section 47 of ITA.	No capital gains tax liability if it is a tax neutral demerger, and if the transaction is covered under Section 47 of ITA.

(Table Contd.)...

...(Table Contd.)

Carry Forward of Losses	No carry forward of losses	Carry forward of losses if change in shareholding does not exceed 49%	No Carry forward of losses	Carry forward of losses if conditions under Section 72A of ITA are satisfied.	Carry forward of losses if conditions under Section 72A of ITA are satisfied.
Value Added Tax	Value Added Tax not applicable	Value Added Tax not applicable	Value Added Tax applicable which usually ranges between 0%-13.5% depending on the nature of goods.	Value Added Tax not applicable	Value Added Tax not applicable
Stamp Duty	Rate of stamp duty payable on the slump sale is state specific	0.25% of the sale consideration	Rate of stamp duty payable on the asset purchase agreement is state specific	Rate of stamp duty payable on amalgamation is state specific	Rate of stamp duty payable on demerger is state specific

CHAPTER

9

Export & Import Business

1. INTRODUCTION

1.1 International trade between different countries is an important factor in economic growth of a country. In an increasingly globalized world, in order to earn foreign exchange to finance critical imports like crude oil and petroleum, and to create employment opportunities for its population, a large country of India's size has to necessarily expand & diversify its exports. It provides incentive to increase both local as well as foreign investment and technological advancement, resulting in economic growth and increase in the foreign exchange earning of a Government.

1.2 Since the Liberalization-Privatization—Globalization regime began in 1991, successive Governments have constantly aimed to expand India's share in world trade, while at the same time attracting Foreign Direct Investment (FDI). A series of measures have been taken to promote exports over the years, such as cheaper and easy finance, cash incentives, import replenishment, duty drawbacks and fiscal incentives under direct taxes. Sometimes they have been sector specific and sometimes general. The Government has power under Section 5 of Foreign Trade (Development and Regulation) Act, 1992, to notify such incentives. The current policy guiding the Government is the Foreign Trade Policy (FTP) 2015–20. The objectives of this Policy are to increase the exports of goods and services, generation of employment and increasing value addition. This was sought to be achieved by various export-friendly innovations and simplifications like merger of reward schemes, new schemes for promotion of merchandise and service exports, incentivising e-commerce exports, encouraging procurement of capital goods from indigenous manufacturers under the EPCG scheme etc, which was in keeping with the "Make in India" initiative of the current Government. Given the slowdown in the Global economic scenario in the recent years, volatility in commodity prices and increase in protectionism, the policies of the Government become all the more crucial for the sector.

1.3 Since export trade cannot be allowed to be conducted in an unregulated or unbridled manner thereby, upsetting or adversely affecting our domestic economy, it is necessary to enforce Governmental controls. The export and import control in India is exercised through various

regulatory enactments in accordance with which exports are either prohibited or regulated, such as the Foreign Exchange Regulation Act, 1973, now replaced by FEMA 2000; Dangerous Drugs (Import, Export and Transhipment) Rules; 1957; Antiquities (Export Control) Act etc.

Presently, the FTP 2015–20, CBEC Customs Manual 2015 and Exchange Control Manual published by the RBI and its Master Circulars No. 13&14 of 2015–16 dated 1st July 2015, provide the statutory provisions relating to exports and imports.

1.4 India shipped US$ 295.8 billion worth of goods around the globe in 2017. According to estimates, India's exported goods plus services represent 18.4% of total Indian economic output or Gross Domestic Product. The following export product groups represent the highest dollar value in Indian global shipments during Apr. 2017–Jan. 2018 (Source: DGFT Bulletin on Foreign Trade February 2018):

1. Petroleum Products-$30.21 bn
2. Pearls, Precious & Semi-precious Stones-$20.94 bn
3. Gold & Other Precious Metal jewellery-$10.81 bn
4. Drug Formulations, Biologicals-$10.58 bn
5. Iron & Steel-$9.31 bn
6. Rmg Cotton incl Accessories-$6.91 bn
7. Motor Vehicles-$6.81 bn
8. Marine Products-$6.36 bn
9. Products of Iron & Steel-$5.56 bn
10. Organic Chemicals-$5.40 bn

At the same time, India imported US$444.1 billion worth of goods from around the globe in 2017, down by-4.7% since 2013 but up by 24.5% from 2016 to 2017.

2. BUSINESS OPERATION & PROCESSES

2.1 Process of Export

2.1.1 The foreign buyer can pay for the goods either:

a. By making payment in advance.

b. Through Letter of Credit/ Letter of Undertaking.

c. By making payment against documents.

d. Through Bill of Exchange.

2.1.2 Letter of Credit/ Undertaking: Usually exporters accept this method of payment. A Letter of credit is an assurance given by the importer's bank on behalf of the Importer that the Importer's bank would make payment of the stipulated amount to the exporter on shipment of goods or delivery of shipping documents to the exporter's bank. Exporters generally insist on having an irrevocable and confirmed letter of credit.

2.1.3 Payment Against Documents: Here the importer gives an assurance to the exporter that the former would make payment to the latter on receipt of shipping documents. After shipment, the exporter sends all documents to the Importer's bank through his bank and the former passes them on to the Importer and the payment of the value of goods is remitted to the exporter's bank.

2.1.4 Bill of Exchange: This is an "instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay money only to or to the order of a certain person or to the bearer of the instrument".

2.2 Customs Clearance and Shipment

The procedures involve a series of steps and substantial documents.

From a legal standpoint, a Bill of Lading is:

a. A format receipt by the ship owner or the master of the ship acknowledging that goods of the stated specifications, quantity and condition have been received in a certain ship or at least received in the custody of the ship owner for the purpose of shipment.

b. A memorandum of the contact of carriage, repeating in detail, the terms of the contract which was in fact were concluded prior to the signing of the bill; and

c. A document of the title of the goods enabling the consignee to dispose off the goods by endorsement and delivery of the bill of lading.

Bills of Lading are usually made out in sets of four. By practice and custom the Bill of Lading has been made transferable. If the shipper assigns the Bill of Lading and delivers to the transferee with the intention of passing the property in the goods, the transfer of the Bill effects the transfer of property also. A consignee to whom goods are to be handed over is named in the Bill of Lading and it is customary to add the words 'or order' after the name of consignee. In some cases the exporter may have the Bill made out to his own order or in the name of the Bank. The consignee or the consignor, as the case may be, may transfer the Bill either by a special endorsement i.e. an endorsement which names the transferee to whom the delivery is to be made or by an endorsement in blank i.e. without naming an endorsee. For shipment of goods, the exporter has to approach the Shipping Company who issues a "Shipping Order" containing detailed instructions regarding loading and shipment of Consignment and a copy of it is endorsed to the captain of the vessel. A Mates' Receipt is issued by the Chief of the Vessel after the cargo is loaded. It contains the name of the shipping line, vessel, port of loading, and *it contains the name of the shipping line, vessel, port of loading*, port of discharge, place of delivery, numbers and lids of containers, description of goods, shipping bill number date etc. The mates' receipt is of a transferable nature and must be presented immediately at the shipping company's office to be exchanged into a Bill of Lading.

2.3 Payment to Suppliers

For making payment for goods imported under OGL or a special general license, the authorised dealer in foreign exchange will either open letters of credit or make remittances after ensuring themselves that the goods have been properly imported for making payments for the imported goods not covered by the aforesaid two licenses. The importer has to produce before the authorised dealer, an exchange control copy of the import licence. Thereafter, the authorised dealer will arrange the requisite foreign exchange. Though a letter of credit can be opened on the basis of the exchange control copy of import licence in advance of the dispatch or shipment of consignment remittances, however, remittances are to be made only on receipt of the shipping documents.

2.4 The Duty Entitlement Pass Book (DEPB) Scheme is a modified version of the advance licence concept and was introduced on 1st April 1997. This scheme is intended for exporters not desirous of going through the licensing route. Under advance licences, exporters ship their goods and obtain a licence to import raw materials necessary for manufacturing the shipped goods. The volume of imports is controlled through input-output norms that specify the import entitlement on the basis of the quantum of exports. The objective of the DEPB Scheme was to remit the basic and special customs duty payable on the import content in exported products. This scheme envisages that upon export, an exporter gets a credit in the form of DEPB Certificate equivalent to the amount of basic import duty which he would have paid for importing the raw material which has gone into the goods so exported. The input/ output ration and the rate of credit to be given per unit is predetermined.

2.5 EPCG Scheme

The EPCG Scheme allows exporters to import machinery duty free or at confessional duty if the importer agrees to achieve a fixed export target within a specified period of time. Capital goods at Zero or confessional duty can be imported subject to an export obligation over a period of time. The period to time for fulfillment of export obligation is specified and is usually five to eight years and obligation is 4 to 8 under the FOB value of capital good. The scheme was very popular when customs duty on capital goods was high. Currently, under the EPCG Scheme import of capital goods carry 10 per cent customs duty though duty free imports are also permitted, subject to a minimum (also specified) import volume. Exemptions are available for certain sectors like agriculture and garments even if the minimum floor limit is not met.

2.6 Duty Drawback on Export Goods: The Duty drawback scheme is administered by the Directorate of Drawback in the Ministry of Finance. Drawback admissible on exports is worked out and disbursed to the exporter by the concerned Commissioner of Customs/Central Excise incharge of Port/Airport/Land Custom Station or Foreign Post Office through which the goods are exported and at such amount or at such rate as determined by the Directorate of Drawback for each type of commodity. Duty drawback in relation to any goods manufactured in India and exported, means the rebate of duty chargeable on any imported materials or excisable materials used in manufacture of such goods.

2.7 Drawback Claims: There is no specific form for claiming duty drawback on goods exported. The drawback shipping bill itself is treated as a claim bill. The drawback is finalised after ensuring that the goods have been examined by the Customs and cleared for exports. The payment of drawback is made by the Customs House/ Central Excise Collectorate having jurisdiction over the port/ airport/ land customs stations through which the exports are effected. At a large number of Customs stations, operations have been computerized. These stations handle more than 90% of India's export cargo. At these stations drawback is mostly paid to the exporter's bank account within 48 hours through the Electronic Date Interchange (EDI) System.

2.8 Export Financing

An exporter often requires financial assistance from his bank at both pre-shipment and post shipment stages. Exporters avail of pre-shipment credit, packing credit and post-shipment credit from the Indian commercial banks and foreign commercial banks in India. Post-shipment credit, medium and long term, on deferred payment terms is availed from commercial banks as well as the Exim bank.

2.9 Export Houses, Trading Houses & Star Trading Houses

The objective of the scheme of Export Houses, Trading Houses and Star Trading Houses is to give recognition to the established exporters and large Export Houses to build up the marketing infrastructure and expertise required for export promotion. The Registered Exporters having a record of export performance over a number of years are granted the status of Export Houses/ Trading Houses/ Star Trading Houses/ Super Star Trading Houses subject to the fulfillment of a minimum annual average export performance in terms of FOB value or net foreign exchange earnings on physical exports prescribed in the Exim Policy.

Merchant as well as manufacturer exporters, service producers, Export Oriented Units (EOUs)/ Units located in Export Processing Zones (EPZs), Electronic Hardware Technology Parks (EHTPs)/ Software Technology Parks (STPs) are eligible for such recognition. Weightage is also given to specified categories of exports. This include triple weightage on FOB or net foreign exchange on the exports of goods manufactured

by SSI/ Cottage/ Handloom/ Handicraft sectors and double weightage on export of goods manufactured in the North-East. Exports of subsidiary of a limited company are counted towards export performance of the limited company for purposes of recognition.

The Export Houses, Trading Houses, Star Trading Houses and Super Star Trading Houses Scheme allows the Registered Exporters certain additional benefits under the policy. This is because most of the incentives are performance linked with the FOB value of exports. Moreover, those exporters who attained such status for three times or more become eligible for golden status certificate which in turn enables them to enjoy benefits of export house/ trading house/ star trading house and super start trading house, irrespective of their actual performance thereafter.

2.10 Export Processing Zones (EPZs/ EOUs) are setup as special enclaves, separated from the domestic tariff area by fiscal barriers, are intended to provide an internationally competitive duty free environment for export production at low cost. The Government has established Export Processing Zones (EPZs) at Mumbai, Kandla, Falta, Chennai, Cochin, Noida, Vizag and other places. Of these, the Santacruz Electronics Export Processing zone (SEEPZ) at Mumbai is meant primarily for Electronics Industry and other EPZs are mutliproduct zones.

2.11 STP Scheme: Introduced by the Department of Electronics, is an export-oriented scheme for the development and export of computer software using data communication links or in the form of physical media. For implementation of STP scheme, Software Technology Parks of India (STPI) an autonomous society has been setup by the Government of India under Department of Electronics. Under the STP Scheme, STPs have already been setup in places such as Bangalore, Hyderabad, Chennai, Thiruvananthapuram, Pune, Navi Mumbai, Gandhinagar, Bhubaneshwar, Jaipur, Mohali, Calcutta, Noida and other places. More than 1000 units have already been established in these STPs (Source: Advantage India, a DOE Publication). Applications for setting up STP/ EHTP units are approved by the Director of the concerned STP, if the applications satisfy the conditions for automatic approval. The proposals which do not meet any or all of the conditions for automatic approval, are considered by the inter-Ministerial Standing Committee.

2.12 The Export Oriented Unit (EOU) Scheme is complementary to the EPZ scheme in that it adopts the same production regime but offers a wider option in locations with reference to factors like source of raw materials, port of export, availability of technological skills, etc. The scheme of 100% EOU is administered by the Department of Commerce, Government of India through the Development Commissioners of the Export Processing Zones. Applications for setting up EOU are approved by the Development Commissioners, wherever the proposal meets the conditions for automatic approval. The Secretariat for Industrial Approvals in the Department of Industrial Policy & Promotion and Department of Commerce accords the approval. These units may import free of duty all types of goods including capital goods and restricted items required by such units for manufacture, production and processing. However, prohibited items in the negative list of imports not permitted. Second hand capital goods with a minimum residual life of 5 years are also permitted to be imported by these units. These units are required to earn minimum Net Foreign Exchange Earning of 20% except in certain specified sectors where individual value addition norms have been prescribed. This minimum value addition stipulation is, however, not applicable to units in the electronic hardware sector. Biotechnology units can be setup with positive Net Foreign Exchange Earning.

2.13 Special Economic Zones: In the Export and Import Policy (1997–2002) incorporating amendments made up to 31st March 2000, Government has announced a policy for setting

up of Special Economic Zones (SEZs) in the country. The entitlements to units in SEZs include exemption from customs/ excise duty on capital goods, raw materials, etc., reimbursement of Central Sales Tax paid on purchases from outside the State, 100% foreign equity participation, facility to sell a part of production in the domestic market, and an upgraded infrastructure. Further, these units would have a simplified customs and excise procedures. Units may be setup in SEZ for manufacture, trading, including repacking, labeling, minor processing, reconditioning, repair, reengineering or for service activity. Sales in the Domestic Tariff Area by SEZ units shall be subject to positive foreign exchange earning, payment of full Custom duty and import policy in force. Only Units having minimum investment of Rs. 50 lakhs in plant and machinery are allowed to be setup in SEZ.

A critical question is to examine whether assessees have shown premium on sale of Special Import Licenses premium on sale of certain unused categories of export entitlements (quotas) granted on the basis of past export performance, interest earned from temporarily invested surplus funds of the export oriented undertaking, etc. in their returns. Also, in view of the Supreme Court Judgment in *CIT vs. Sterling Foods* (1999) 237 ITR 579 (SC), whether these incomes would be chargeable to tax under the provision of law as contained prior to and after the Finance Act, 2000.

3. MALPRACTICES AND TAX EVASION

During the last few decades economic offences have assumed alarming proportion as a result of which the economic health of the nation has been adversely affected. It is not so easy to track down the offenders since they resort to extremely subtle and complicated modus operandi. They cover a number of overlapping statutes. The perpetrators of these offences are rich people who command a high pedestal in the social hierarchy. In the case of Import and Export business, the Importers and Exporters adopt a number of dubious contrivances and indulge in serious malpractices for evading taxes and circumventing export and import trade control as also other regulatory enactments.

3.1 Manipulations in Invoicing of Imports and Exports

Through frequent visits abroad and after having business dealings over a period of years, the exporters and importers in India develop association with their foreign counterparts and often start entering into collusive invoice manipulations. For instance, an exporter making an invoice which is less than the price actually contracted is under-invoicing his exports. This will result in the difference between the two prices being retained abroad and possibly might be shared by both the exporter and the importer. Such fraudulently accumulated foreign exchange not only remains outside the country thereby upsetting our foreign exchange position but also remains outside the books of accounts of the exporters, thereby leading to concealment under the Income-tax Act. In fact, under-invoicing and over-invoicing of Imports and Exports are directly inter-twined with evasion of Income-tax.

3.2 Under-Invoicing of Exports

Apart from tax advantage by under-invoicing exports the exporter retains funds abroad which could be used by him for a variety of purposes as below:

1. Exporters, their relatives or friends require much larger funds during their visits abroad than what the Reserve Bank releases to them. The foreign exchange released to them by the Government can't even meet a fraction of their expenditure abroad. The funds provided by exporters abroad to their relatives or friends are compensated in India by rupee payment.
2. The illegally retained foreign exchange is afterwards sold out to illegal purveyors of foreign exchange who need foreign exchange to finance smuggling activities and for compensatory payments

(unauthorized remittances) to Indians in India. In most developed countries there is no exchange control, with the result that there are a large number of well-organized syndicates who freely quote and advertise for remittances to any country at rates different from the official rates through compensatory channels. These Syndicates purchase foreign exchange and transmit the same outside that country through a network of agents and sub-agents in various countries.

3. Foreign exchange is also, at times, used by Indian firms for purchasing plant and machinery and spares, etc. and because of inadequacy of foreign exchange sanctioned by the government for their requirements, they use their clandestinely accumulated funds abroad. This also saves Customs duty at the point of import.

4. Secret reserves are, sometimes, allowed to accumulate in fixed deposits or put in lockers abroad since there is almost complete secrecy in banking transactions.

3.3 Over-Invoicing of Imports

It is resorted to acquire foreign exchange abroad. This is done only for items where import duty is low. In case of items on which duty is high, it is not worthwhile to over-invoice the imports because of a higher duty offsetting the benefit. The import of Plant and Machinery and stores etc. generally provides a good avenue for piling up foreign exchange abroad. Thus the actual cost of machinery may be inflated by adding overriding commission arranged to be paid to Directors of the purchasing company. The secret commission is then retained in foreign banks. After having settled the transaction with the foreign seller, the Indian Importer chooses the shipper and the Insurance company and strikes deals with them and receives secret commission which is retained abroad.

This methodology was seen when Directorate of Revenue Intelligence (DRI) unearthed a Rs. 29,000 Crores Coal import scam in 2014. This scam involved companies inflating the value of coal imports from Indonesia for their power plants, thus siphoning money abroad. The DRI found that almost every importer, including the reputed corporates, have indulged in overvaluation of coal imports. The imported coal from Indonesia is overvalued to the extent of at least two times the actual value declared in the country of origin. The modus operandi adopted by the companies is that while coal imports would directly be shipped from Indonesia, the invoices will be routed through an intermediary based either in Hong Kong, Singapore or Dubai. "The inflated amount will be sent to the intermediary who, in turn, would remit the actual value to the Indonesian supplier. The overvalued component would be diverted to tax havens. The intermediary is either related to the importer or handles such operations on commission basis.

It is important to note that in this case, the companies did not avail of the Preferential Trade Agreement that extended concessional duties for imports from Indonesia. Steam coal imported from Indonesia attracts zero rate of duty and the companies are required to produce country of origin certificate issued by the supplier. The companies did not avail of this facility because in such a scenario, the companies would have to produce the certificate which would carry the real value.

3.4 The opposite devices of over-invoicing the exports and under-invoicing the imports also take place:

The natural concomitant of this reverse process is creation of a big demand for foreign exchange abroad. Though on the surface it may appear that there is no loss in terms of foreign exchange when imports are under-invoiced but in reality, importer has to secure foreign exchange from the unauthorized and illegal channels to pay the differential abroad. This also results in loss of customs duty. Similarly, it may superficially appear that over-invoicing of exports results in greater earning of foreign exchange. The

exporter in all such cases has to resort to other manipulations or illegally purchase foreign exchange from unauthorized sources to meet the differential. Over-invoicing of exports occurs when certain export promotion schemes are in force, according to which, import incentives and replenishment licenses are highly attractive e.g. Value based advance licencing. Thus under-invoicing of exports will normally not be resorted to in commodities whose export is tied up with a scheme of export incentives or replenishment licences.

Leakage of foreign exchange also takes place by importing worthless goods or goods of no value, while mentioning the correct value in the documents. Sometimes, remittances are also made against forged import licence or against licences obtained fraudulently on mis-representation. In some cases, the exporter may mention correct value at the time of passing through Customs but subsequently seek reduction in value of exported goods on false grounds. Another important area is the unauthorized diversion of the exported goods initially consigned to rupee payment countries but deflected on way to the general currency area. The exporters who resort to this malpractice, do so mainly for generating foreign exchange for their own use and for building secret reserves abroad. Whenever such incidents occur, Assessing Officers should thoroughly probe the matter to ascertain the reasons that necessitated and also the extent of unaccounted money earned in the process. Reserve Bank of India (Exchange Control Development) as also Enforcement Directorate (Foreign Exchange) can be of immense assistance in such matters.

3.5 Use of Shell Companies for Non-Existent Import Transactions

Shell companies are basically companies with no business activity and no physical setup as they exist only on paper. These companies do not conduct any kind of economic activity such as manufacturing a product or rendering a service to its customers. They are setup for activities such as avoiding payment of taxes, money laundering etc. These bogus companies are an ideal instrument to turn black money into white, as all the transactions that are undertaken are shown as legitimate on paper.

Illegal activities generally carried out by a shell company includes tax evasion, bankruptcy frauds, fake services schemes, market manipulation and money laundering. One of the aims of a shell company is to turn the illegally held money into legal wealth for which tax has been paid and the source is accounted for. These companies are typically created by the person(s) that hold(s) the unaccounted money.

Often companies that want to hide their actual profits buy and sell through shell companies which are based in one of the tax havens. Transacting through these shell companies ensures that the initiating company does not have to report its transactions (due to the country's tax laws) and hence is successful in avoiding taxes.

Traditionally, shell companies in India have been used for rotation and siphoning off of funds by the promoters through fictitious sales, inflated purchases, unjust commissions or for creation of equity for ultimate owners who are shielded by cloaks of deceit.

The modus operandi is simple. The perpetrator floats a number of companies usually with the same registered address and with directors who despite being 'real persons' are untraceable or completely unrelated, or are usually poor and unlettered lending their names for a token payment. Dummy directors are used for anonymity or deniability, who pre-sign cheques and documents and hand over to the principals.

Many times, bank officials are hand-in-glove in these operations, including overlooking KYC norms and background checks for accounts opened in their branches. Often, suspicious transactions are below the threshold of automatic banking software triggers and hence can go undetected for years unless they form part of other investigations.

The 'seed' receipt is introduced as capital in the bank account of one shell company; this money

is rotated through bank accounts of a set of shell companies—all transactions being completed the same day in the same branch of the bank. Thus, each company shows identical sums as capital and instantly lends or invests in another company. The exercise is repeated several times. As banks need to balance their books only at the end of the day, colluding bankers ensure that the money rotates through 5–10 accounts in a day, i.e. the money multiplies 10 times in a day, not backed by real transactions, but the daily credit and debit balances in each account falsely display robust business activity.

In case of a fraud involving foreign exchange, large remittances are sent overseas towards fictional imports of stocks and machinery, advances, commissions, etc. Later, money is moved from such overseas accounts into another set of shell companies. Often, such money comes back through another bank account as receipts from exports or payments for share capital in listed and unlisted companies (called round tripping). The Supreme-court appointed SIT observed in 2016 that investments from Cayman Islands, a tax haven, alone amount to Rs. 85,000 crore in India, highlighting the role of tax havens in money laundering. In either case, the perpetrators avail import credits from the government, like duty drawback on imports and export benefits. Otherwise, these shells hold properties or land on behalf of the real owners or hold payments for fictitious sale of goods or services in India till the money gets 'bleached white'.

4. DETECTION

4.1 Experience has shown that collusion of Indian Importers and Exporters with their foreign counterparts is quite rampant, resulting into various malpractices and tax evasion. Such cases deserve sustained and in-depth investigation.

4.2 Abnormal over invoicing of exports although bound to result in handsome gross profit, should not mislead the Assessing Officer. The officer should be vigilant in cases of very large profit margins. In such cases the assessee is likely to raise bogus debits or inflate expenditure and make adjustments to reduce the final net profit. In case of over-invoicing of exports and under-invoicing of imports, the Indian party would be required to remit funds abroad secretly to the extent of the differential. Therefore, the accounts of the foreign associates as appearing in Indian party's books should be minutely scanned. Investigation Units while conducting searches have found cases of gross over-invoicing of garments and footwear against which bogus purchases to a substantial extent were found. The 'profits' generated were misused for controlling and rigging share price movements. Moreover, by a faster turnover, the exporter availed of undue benefits under the Value Based Advance License (VABAL) scheme.

4.3 Income-tax Act provides for 100% deductions in respect of software exports. Bogus software exports have replaced fictitious diamond exports as a major form of laundering money. A noteworthy feature of the Indian software export as per the Economic Times report is that the bulk of over 600 software companies in India (over 300 companies) export just about Rs. one Crore or less. In the software export sector, 'exports' do not cross the border in a conventional manner and thus avoid the rigour of customs scrutiny. Exporting duplicate diamonds in the garb of real stones had been vogue during late 70s and 80s. Duplicate diamonds and rice have been used as cover for laundering money. In the 90s it is software export. The Exim benefits available to the software sector include:

a. EPCG Scheme with a very low limit of Rs.10 lac under which zero duty benefit on capital goods is available

b. Nil duty on software imports and exports.

c. Special Import Licences (SIL) @ 15% FOB value of export or 25% of net foreign exchange earning is allowed.

No other Sector in export enjoys such liberal benefits. As there is no physical movement of goods in case of software exports, it is easy to cash on the incentives, particularly, as Income-tax exemptions are also available. Black money is paid in the country for which equivalent amount is arranged to be sent abroad. Bogus software export serves two purposes—

a. The money that comes from abroad in the guises of payment received for software export gets exemption under Sections 10A, 10 B and 80 HHE of the Income-tax Act.

b. Secondly, the company could show on paper fictitious expenses incurred for completing the work for the foreign client and send foreign exchange abroad.

Finally, a software firm can show better performance in the books and build up an unreal image of its profits to enable it to go for public issue. US Revenue authorities are likely to take cognizance of the matter and are inquiring the purchases made by US based software companies on the issue of transfer pricing. The US companies too get a deduction as the purported software purchases made by the company from an Indian or any foreign company can be added to its expenses. In such cases, wherever appropriate, clauses of double taxation avoidance treaty relating to suppression of incomes should be invoked.

4.4 Hawala dealers in the country are using diamond export as a new modus operandi in their multi-million transactions worldwide. The diamond export cover makes them eligible for government loan, with public money serving as liquid cash to feed the hawala transaction. The method is also used to exploit the currency depreciation situations, for gaining foreign exchange. The nexus between hawala dealers, terrorist organisations and travel agents, has for instance been reported. The modus operandi works is that the hawala traders procure demand for the export of diamond to a foreign country. At this stage, the 'exporter' avails pre-shipment credit upto 180 days from the bank with the demand order serving as guarantee. The Reserve Bank of India permits exporters to get post-shipment credit after the said goods are sent and payment from the client is awaited. This is availed by these dealers. The hawala dealers posing as 'exporters' can create a situation of managing a loan in this manner for one year. Meanwhile, after the diamond is exported, the hawala agent abroad avails loan facilities there. Often, while ordinarily it is felt that the diamond trade is on the rise, it is actually the same set of diamonds doing the rounds. A rising turnover also implies many other export benefits to the exporter. The export of such diamonds and their import can be also be timed with the dip and rise in the exchange value of the rupee. The remittances for 'importing' diamonds are sent on the day when the value of the rupee depreciates i.e. registers a substantial fall *vis-a-vis* the dollar. In such a case, the amount sent out of the country in foreign exchange would be more. The diamonds are brought back when the value of the rupee recovers. The money coming in is less than the amount going out. Such manipulation could lead to putting additional pressure on the Rupee. In certain press reports, it has been alleged that certain Sections abused VDIS by buying diamonds with their undisclosed income and declaring them under VDIS. These diamonds also provide a hawala cover.

4.5 In cases, where information about under-invoicing of exports has come from Reserve Bank of India, Customs House or where the Assessing Officer has some hunch during the course of investigations, he must go deep into the entire gamut of purchases and sales of the goods exported or imported. He should also closely see the rates referred to in the contract cable and contract memo. The contract between the foreign importer and an Indian exporter is usually made through cables and followed by contract memo, the latter being the confirmation. Then these rates should be compared with invoice rates and in cases of suspicion they can be compared with prevailing market rates. Quite often, the collusive arrangements are so

camouflaged that there appears no discrepancy or irregularity. Often the deal is so arranged that the goods actually exported are of a superior quality to those shown in the invoice. In such cases the only method of detection is to follow up the origin of goods exported and verify whether the description as per the invoice is correct.

4.6 Invoice Manipulation by Foreign Companies

Over invoicing of imports is frequently resorted to by the foreign companies having branches or subsidiary companies in India. For instance, Plant and Machinery and stores etc. if purchased from the parent company or any other connected company are billed for at a higher price than their normal sale value. This is done with a view to transfer profit from India to the parent body abroad. Again if these items are purchased from dealer other than the parent company, the parent company may retain the commission on these transactions. It is, therefore, imperative that the imports by assessees having foreign connections should be meticulously and deeply examined. Under invoicing of exports may be resorted to by foreign companies operating in India, although, of course, for different reasons. They do so mainly with the objective of 'transfer pricing' to pass profits to an associate company located in a country, where the average tax rate may be lower than India.

Transfer prices are the charges made when a company supplies goods, services or finance to another company to which it is related. With globalisation, it becomes a reality, as prices charged impact the tax paid by two related companies, for instance, a foreign company and its subsidiary an Indian company. By resorting to transfer pricing such related entities can reduce the global incidence of tax by transferring higher income to low tax jurisdiction or greater expenditure to those jurisdictions where the tax rate is very high. Import of raw material, semi-finished goods for assembly, and most important of all, intellectual property such as know-how and technologies are areas prone to transfer pricing in a developing country like India. In India, provisions relating to transfer pricing in the Income-tax Act, have recently been tightened. Multinational companies often use transfer pricing as a tool for minimizing the global avoidance of tax for the group as a whole. Many multinationals have setup subsidiaries producing for software including back-office operations etc. in India. The modus-operandi involves over invoicing the export of software by the Indian subsidiary to the multinational parent abroad as these are likely to be exempt under Section 10A and 10B of the lncome Tax Act. The parent company abroad would get the benefit of claiming higher deduction on account of higher expenditure and reduce its taxable income in that country. Though there would be foreign exchange inflow, the benefit would get substantially neutralized when the Indian subsidiary declares dividend on inflated profits shown by it and repatriates the same to the parent company in foreign currency.

4.7 Manipulation through Shell Companies

The government has launched concerted efforts to streamline the economy by rooting out black money and unscrupulous companies. In the month of August 2017, the Securities and Exchange Board of India issued a directive to stock exchanges to take action against 331 shell companies. In his Independence Day speech 2017, the Prime Minister said that around 1.75 lakh shell companies had been de-registered.

At present, there is no clear definition for the term shell companies in India. However, in the US the term shell company has a clear definition. A shell company can be considered to be an organisation that does not have any active business operation, neither does it have possession of any significant assets. Some shell companies are setup for legitimate purposes; however, there are many that have been established for illegitimate purposes.

An international, inter-governmental body was formed in 1989 for "combating money laundering, terrorist financing and other related

threats to the integrity of the international financial system". Known as the Financial Action Task Force (FATF), it has 180 members with India also being a part of it. The FATF has laid down rules and processes to deal with the menace created by such companies.The STRs generated by FIU-IND which was se up under the FATF should give us a clue about frequent and circuitous transactions between related shell companies.

Apart from defrauding the government of large amounts of taxes and aiding dangerous activities these companies can also be a cause of concern for small investor. Often dummy companies will exist only in paper and have no office or staff working for them. Researching their business activity should also give one a clue.

MCA21, the portal on which all corporate filings reside, is a wonderful starting point for tracking and mining data for companies sharing characteristics like common directors, same registered address, little or no business, occasional large transaction, etc, to create early warnings against shell companies. A central KYC registry to track multiple transactions by one individual or entity will help create transaction histories of individuals and entities.

4.8 Manipulation Through Shifting of Profits from Eligible Unit to Non-eligible Unit in case of Companies having EOUs in SEZs & (Domestic Transfer Pricing)

The SC in the case of *CIT vs. Glaxo Smithkline Asia Pvt Ltd* (2010) 195 Taxman 35(SC) recommended introduction of domestic TP provisions. The Court has stated in Para 4 of its order "The main issue which needs to be addressed is, whether Transfer Pricing Regulations should be limited to cross-border transactions or whether the Transfer Pricing Regulations be extended to domestic transactions. In the case of domestic transactions, the under-invoicing of sales and over-invoicing of expenses ordinarily will be revenue neutral in nature, except in two circumstances having tax arbitrage—(i) If one of the related Companies is loss making and the other is profit making and profit is shifted to the loss making concern; and (ii) If there are different rates for two related units (on account of different status, area based incentives, nature of activity, etc.) and if profit is diverted towards the unit on the lower side of tax arbitrage. For example, sale of goods or services from non-SEZ area (taxable division) to SEZ unit (non-taxable unit) at a price below the market price so that taxable division will have less profit taxable and non-taxable division will have a higher profit exemption.

To detect such cases, the documents which have to be maintained separately for exempt and non-exempt units should be called for and examined. The date of production, the permissions etc need to be examined. The production output has to be examined in correlation with the machinery installed, their capacity, the labour utilised and the input raw material claimed to have been used to establish whether the given ratios are correct, whether the suppliers providing raw material have that capacity or wherewithal. It also needs to be seen whether the sale is being made out of India to foreign purchasers or to other EOUs of same group or other companies, which is not permitted. Very high production and low cost of raw material/ machinery in exempt unit and low production and high cost of raw materials in non-exempt unit will give a clue to the tax evasion being carried out.

5. ISSUES RELATED TO INCOME-TAX ALONGWITH RELEVANT LANDMARK JUDICIAL DECISION, CBDT CIRCULARS AND INSTRUCTION IN BRIEF

5.1 The various issues of the Export Import business related to Income-tax are as follows:

1. Over-invoicing of exported goods or services to claim excessive exemption on export proceeds—At first, this may seem to show good profits and hence more tax, but the availing of exemption and hence

suppression of real profit makes it an Income-tax issue.

2. Over-invoicing of imported goods or services to claim excessive revenue expenditure or excessive depreciation on imported capital goods.
3. Under-invoicing of exported goods or service to withheld the excess money in foreign countries for expenditure or remitting it to India through Tax Haven Countries in the form of capital receipts.
4. Under-invoicing of import of goods or services to utilize the unaccounted money lying outside India—At first, this may seem to show good profits and hence more tax, but this indicates use of unaccounted money accumulated outside and thus is an Income-tax issue.
5. Bogus Export/ Import of goods or services– To inflate expenses to reduce tax, or to launder money. Use of shell companies is done frequently here.
6. Export of goods or services out of purchases from non-existent entity/party—To launder money.
7. Shifting of profit (in the form of sales or expenses) of non-eligible unit to eligible unit to claim excessive exemption—Manipulation of books of accounts to show more expenses at non-eligible unit and more revenue at eligible unit, thus shifting profit to eligible unit to gain exemption.
8. Non-fulfillment of all conditions for exemption.
9. Goods or services delivered to nominee of importer in India but claimed exemption on sales proceeds.

Most of the provisions of Income-tax related to Export-Imports, such as 10A, 10AA, 10B, 80HHC etc have now elapsed, as also since the Government is now in the process of phasing out all such exemptions and deductions.

6. SOURCES OF INFORMATION, DATA COLLECTION/COLLATION LIKE SEBI, GST, EXCHANGE OF INFORMATION

1. **Goods and Service Tax Department (GST):** This department receives export and import data alongwith party details by way of monthly/ quarterly GST return. Hence, it can be obtained to verify the genuineness of import/ export transactions.
2. **Export Credit Guarantee Corporation (ECGC):** It provides export credit insurance support to Indian exporters. Therefore, a declaration of Valuation of the Exported goods or/ and services by the exporter is being maintained by ECGC. Hence, it can be obtained to verify the disclosure of transaction value in ITR.
3. **Directorate General of Foreign Trade (DGFT):** An organisation to promote/ facilitate/ regulate the export/ import business in India. It maintains data of import/ export activities in India. Data obtained for a particular import/ export business may be compared with the trends of assessee to know the suspected manipulation area.
4. **Foreign Tax and Tax Research Division of CBDT (FT&TR):** Information/ transaction details may be called from Foreign Countries under Information Exchange Treaty to know the genuineness of export/ import transaction.
5. **Custom Clearing Agent/ House:** A copy of entire documents required for clearing may be called to know the genuineness of export/ import of goods or services.
6. **Banking Institutions (Bank):** Information may be called from the banks, including Exim Bank, to know the particulars of foreign parties to/ from whom money was remitted/ received and its purpose.

7. **Development Commissioners in-Charge of SEZ:** Information may be called from them to know the genuineness of the exports made from EOUs in SEZs across the country.

8. **Regional Economic Intelligence Committee:** It is the apex forum overseeing government agencies responsible for economic intelligence and combating economic offenses in the respective states of India. Since it includes representatives from Customs, RBI, Jt. DG of Foreign Trade, GST and DRI, the information received through REIC can serve as a valuable input.

7. RELEVANT LEGISLATIONS AND REGULATORY FRAME WORK & COMPLIANCES REQUIRED

a. Foreign Trade (Development & Regulation) Act, 1992.

b. Foreign Exchange Management Act 1999

c. Foreign Trade Policy 2015–2020.

d. CBEC Customs Manual 2015.

e. RBI Master Circular No. 13/2015–16 dated 1st July, 2015 on Import of Goods and Services.

f. RBI Master Circular No. 14/2015–16 dated 1st July, 2015 on Export of Goods and Services.

7.1 ICDS—Income Computation and Disclosure Standard

ICDS is framed on the basis of accounting standards notified by Ministry of Corporate Affairs (MCA) vide Notification No. GSR 739(E) dated 7th December, 2006 under Section 211(3C), of erstwhile Companies Act, 1956. However, MCA had notified in February, 2015 a new set of standards called 'Indian Accounting Standards' (Ind-AS). How will ICDS apply to companies which adopted Ind-AS?

Well, ICDS shall apply for computation of taxable income under the head "Profit and Gains of Business or Profession" or "Income from Other Sources" under the Income-tax Act. This is irrespective of the accounting standards adopted by companies i.e. either Accounting Standards or Ind-AS.

7.2 Income Computation and Disclosure Standard VI (ICDS-VI) relating to the effects of changes in foreign exchange rates. For details please see Notification No. 87/2016-Income-tax Dated: 29/09/2016

8. CASE STUDIES

8.1 ABC Software Group

A survey action under Section 133A was conducted in the case of ABC Software group. The main concerns of the group are Alibaba Technical Solutions Pvt. Ltd., AladinInternet Marketing Pvt. Ltd., Simba Software Systems Pvt. Ltd., M/s Mufasa IT Pvt. Ltd, Pumba Browsers Pvt. Ltd and Timoe Jewellers Pvt. Ltd. The key person involved in the group is Sh. Chorwaland Sh. Dakuwal.

In the case of Alibaba Technical Solutions Pvt. Ltd., AladinInternet Marketing Pvt. Ltd., Simba Software Systems Pvt. Ltd. and M/s Mufasa IT Pvt. Ltd, there was a common business premise covered under Section 133A of the Act and the survey commenced at night as these entities were in the business of providing software technical solutions and were operating at night due to their business connection with western countries. With respect to Timone Jewellers Pvt. Ltd, where jewellery business is carried out, the premise was duly secured at night so that it could be covered under Section 133A after sunrise i.e during the normal hours of the business.

During the course of the survey action in the above stated business premise, cash amounting to Rs. 48 Lakh was found. However, as per the books of accounts, the cumulative cash in hand available as on date in the case of all

the assessee companies put together was only Rs. 3 lakh. The Accountant of the group, in his statement recorded on oath stated that the books of accounts were duly updated. Therefore, there was an apparent unaccounted excess cash of Rs. 45 lakh. As the assessee group could not provide any satisfactory explanation in respect of the excess cash found, the survey was converted into search under Section 132 of the Income-tax Act and search warrants were executed.

During the course of the search it was found that the in the case of Alibaba Software Systems Pvt Ltd, huge amount of other liablilites in the form of employee expense payable was accumulating every year. From FY 2014–15 to FY 2016–17, the cumulative other liabilities came to Rs. 22 crores. When assessees was asked to produce the details of the employees to whom the salaries/employee benefits were payable, they could not furnish the details of the same. The Director of the Company, Sh. Chorwal, in his statement recorded on oath, admitted that they have introduced bogus employee expenses amounting to Rs. 20 crores over a period of three years.

During the course of survey action in the case of Timone Jewellers Pvt. Ltd, excess stock amounting to Rs. 2 crores was found. When Director of the company was asked to explain the same, he could not furnish any explanation. Therefore, excess jewellery stock found represents unaccounted investment in stock of the company.

During FY 2016–17 and 2017–18, the assessee group has sold Bitcoins worth Rs. 10 crores. During enquiry the Directors of the assessee group stated that that Bitcoins were received as a part of export remittance in respect of software services exported. When they were asked to furnish the Softex forms, i.e the statutory forms filed before the Customs Authorities/STPI in respect of the relevant export sale and the Bank Realisation Certificates (BRC) in respect of such remittances, they failed to produce the relevant documents. Therefore, *prima facie*, it appears that export proceeds in Bitcoins have been received in violation of provisions of FEMA. Accordingly, a reference to the Enforcement Directorate was made in this case.

8.2 Mickey Refinery Ltd.

Mickey Refinery Ltd (hereinafter referred to as MRL) is engaged in import of coal of Indonesian origin besides other business activities. The intelligence gathered during pre search revealed that MRL group in the guise of cross border transactions of its business concerns was suppressing its true profit thereby evading the due taxes thereon. The group was believed to have some foreign subsidiaries/ associate concerns which were being used to work in such a clandestine manner that the true profits of the group did not come in the tax net of India. Accordingly as search and seizure action under Section 132 of the IT Act 1961 was carried out on the group.

The search and seizure in the instant case resulted in the finding that the company was routing some of purchase transactions of coal through certain offshore entities based in Dubai. It is unearthed that such Dubai based entities were indirectly controlled by the Directors/ partners of MRL group concerns in a clandestine manner. Further it was unearthed that such Dubai based concerns were raising commercial invoices of the consignment raised by the Indonesian suppliers. The subject assessee through its key persons has admitted the discrepancy on account of such clandestine activity and offered an amount of Rs 150 Crores as undisclosed income.

However during post search proceedings and while finalizing the appraisal report it was held that the coal imports by the group were being routed through Dubai based concerns with clear aim of defrauding revenue and do away the legitimate tax liabilities and accordingly the claim of assessee that a margin in the range of US$ 2 per MT against which coal import to such foreign entity was treated as basically artificially created claim of bogus expenses. In view of the

above the total detection in the hands of the group is determined at Rs 110,28,31,941/-.

8.3 Over-invoicing Tax Evasion-Non-Fulfilment of Conditions for Claiming Exemption under Section 10B

The assessee firm filed its Return of Income on 30/10/2005 for A.Y. 2005–06 declaring total income at Rs. Nil after claiming exemption under Section 10A of the I T Act, 1961 (hereafter referred to as " Act") amounting to Rs. 62,01,976/-. The return was processed under Section 143(1) at returned income.

The assessee firm claimed that it engages in the business of development of software and eligible for 100% exemption under Section 10B of the Act. Analysis of the assessment records of the assessee indicated that the firm had not developed any software on its own and utilizes the assets, manpower as well as business client of its sister concern. Further, the assessee had declared very low profit and so it was not eligible for exemption in comparison to the profit declared for eligible financial years.

To verify the genuineness of huge profit shown during the exemption period and the claim of exemption under Section 10B, a survey action under Section 133A of the Act was carried out at the business premises of the assessee. During the survey proceedings, it was observed that the firm acquires the assets like computer, software, furniture & fixtures etc, the key employees and business of an existing company. During the course of survey and post-survey enquiry, key employees and main working partner were examined on oath and cross checked with the actual facts and material evidences collected during survey operation, which clearly indicates that the assets, employees, business, business premises and even the clients of the existing company were utilised to start the business in the firm. Therefore, the firm failed to satisfy the basic conditions laid down under Sub-section (2) of Section 10B of the Act to claim the exemption, which was then denied.

8.4 An Alternate Ground was also Taken to Restrict the Exemption under Section 10B

During the post-survey enquiry, it was very clear that one of the partners had been director of a company wherein the company had domestic business as well as foreign clients and when the said director shifted to USA, he took up employment in 1999 with a foreign company and decided to take advantage of the STPL, which was declared in the year 2000, by transferring the business already in existence, manpower & assets of an existing company to a newly formed partnership firm to avail the benefits of exemption under Section 10B of the Act.

Further, it was also noticed during the survey that the main working partner of the firm had substantial pecuniary interest in the business of export clients of the assessee firm but this fact was neither declared in the Tax Audit Report nor in the return resulting into non-examination of the assessee's claim of exemption under Section 10B (7) r.w.s. 80IA(10) of the Act while scrutinizing the claim under Section 10B during the proceedings under Section 143(1) of the Act and during the proceedings under Section 143(3) of the Act in earlier and subsequent assessment years. It is also seen that the assessee has shown 2.88% of net profit in the assessee firm for the year in which the firm is not eligible for exemption under Section 10B against 19.56% to 65.77% of net profit during the period of exemption. From this fact, it was clear that assessee had shown inflated profits during the period of 10 years for claiming higher exemption under Section 10B of the Act and the AO had not examined the issue under Section 10B (7) r.w.s. 80IA(10) of the Act due to non-declaration of material facts either in tax audit report or return of income. Hence, the assessee had purposely tried to avoid its tax liability by claiming wrong/excess exemption under Section 10B of the Act, which was not allowable.

The analysis and investigation shows that as long as assessee had the benefit of Section 10B of the Act, it disclosed abnormal profit as

there was no tax liability but as soon as benefit exhausted the profit margin decline drastically. The reason behind such huge difference is nothing else but to reduce the tax liability by manipulating/ influencing export sale proceeds from the foreign client in which main partner of the assessee had pecuniary interest as well as higher position in the related division of the foreign client. Hence, the profit from the export business eligible for 100% exemption under Section 10B was hereby restricted @ 2.88 % i.e. the rate of profit which was declared after the eligible period for exemption under Section 10B of the Act. Accordingly, only Rs. 3 Lakh (2.88% of Rs. 1.04 Crores) was allowable as exemption under Section 10B of the Act.

Since the assessee failed to comply with the requirement of Section 92E of the Act, penalty proceedings under Section 271BA of the Act was initiated. Further, the assessee has made wrong/ excess claim of exemption under Section 10B of the Act and concealed the income for taxation by way of furnishing inaccurate particulars of income, penalty proceedings under Section 271(1)(c) of the Act was initiated.

By using this modus operandi, partner of the assessee firm manipulated/influenced the export sale quantity as well as value to generate in-ordinary exempted profit for the firm.

9. CHECKLIST FOR AOs

9.1 AO Checklist of Import Purchases

1. Check whether importer has entered into any contract with supplier and terms and conditions for payment.
2. Check in Bill of Lading (BL) name of importer as well as supplier
3. Check whether details mentioned on the packing list and bill of lading are same.
4. Import purchases should be accompanied by following documents.
   i. Sales Contract.
   ii. Commercial Invoice,
   iii. Bill of Lading,
   iv. Insurance Certificate,
   v. Certificate of Origin,
   vi. Phytosanitary Certificate,
   vii. Bill of Exchange,
   viii. Draft Bill of Entry
5. Check whether payment terms, invoice details, BL details mentioned on the Bill of Entry is proper.
6. Check whether any Detention charges/ Demurrage charges have been paid to the clearing and forwarding agents-ascertain the reasons for the payments of demurrage/ detention charges.
7. Ascertain whether demurrage/ detention/ terminal handling charges/ free time allowed for the containers by the suppliers as per the terms of the purchase order to be borne by the suppliers have been recovered from the suppliers.
8. Ensure that the duty credit scrips such as MEIS licenses, advance licences,if any, available for payment of are fully utilised if any.
9. Ensure that the imports purchases have been made within the LC Validity period.
10. Check whether any LC extension/ revalidation charges have been paid.
11. Check whether customs duty has been paid for imports of material inspite of Advance licences being available.
12. Check whether excess time is taken for the clearance of material from the customs over and above the grace period/ free time allowed.
13. Check the agreement/ contract with the clearing agent and ensure that the terms and conditions of the contract are complied with.
14. Obtain the status of Advance licence utilisation.

15. Ensure that import purchases are accounted in books as soon as risk and reward relating to ownership is transferred.
16. Check whether any customs duty/ penal interest/ penalty has been paid towards imports made but export obligation not fullfilled under an Advance licence.
17. Ensure that import purchases are converted using consistent and reliable forex rate in books of account.

9.2 AO Checklist of Export Sale of Goods

1. Check whether exporter has entered into any contract with customer and terms and conditions for payment.
2. Check in Bill of Lading (BL) name of exporter as well as customer.
3. Check whether details mentioned on the packing list and bill of lading are same.
4. Export sales should be backed by copy documents:
   i. Sales Contract.
   ii. Commercial Invoice.
   iii. Bill of Lading.
   iv. Insurance Certificate.
   v. Certificate of Origin.
   vi. Phytosanitary Certificate.
   vii. Bill of Exchange.
   viii. Draft Shipping Bill).
5. Check whether payment terms, invoice details, BL details mentioned on the Shipping Bill is same.
6. Check whether the payment has been received from customer as per sales contract
7. Check the remittance certificate for inward remittance and check that receipts are realized from the same customer to whom exports have been made.
8. Check whether the export obligation have been fullfilled/ short fulfilled before the expiry of the validity of the Advance licence/ export obligation period.
9. Ensure that the documents to be submitted to the bank are processed and submitted in time to avoid any delay in/late credit by the banks in case of sight LC.
10. Check whether there are cases of short payments received from the banks in respect of Export bills.
11. Check whether any penal interest has been paid due to the non fullfilment of export obligation.
12. Check whether any undue delay has taken place for the despatch of goods from the date of the shipping bill.
13. Check whether any amount has been paid towards the extension of the validity of the Advance licence/ revalidation charges towards Advance licences.
14. Ensure that export sales are accounted in books as soon as risk and reward relating to ownership is transferred.
15. Ensure that shipping bills mentions duty drawback and other export incentives and check whether the conditions attached to the same are fulfilled by the exporter.

CHAPTER

10

Capital Market

1. INTRODUCTION

The capital market is vital for the financial system. Capital market provides the support of capital formation in the country. The wave of economic reforms initiated by the government has influenced the functioning and governance of the capital market. The Indian capital market is also undergoing structural transformation since liberalisation. The chief aim of the reforms exercise is to improve market efficiency, make stock market transactions more transparent, curb unfair trade practices and to bring our financial markets up to international standards. Further, the consistent reforms in Indian capital market, especially in the secondary market resulting in modern technology and online trading have revolutionized the stock exchange.

Capital market concerns the industrial security market, government securities markets, and long term loan market. It supplies long-term and medium term funds. It deals with shares, stocks, debentures and bonds. Security dealt in capital markets are long-term securities. It provides a market mechanism for those who have savings and to those who need funds for productive investments. The capital market aids economic growth by mobilising the savings of the economic sector and directing the same towards channels of productive uses. Companies turn to them to raise funds needed to finance for the infrastructure facilities and corporate activities.

The capital market is source of income for investors. When stock of other financial assets rise in value, investors become wealthier, often they spend some of this additional wealth on additional consumption thereby promoting economic growth. Stock value reflects investor reactions to government policy as well, whether the government adopts policies that investors believe will hurt the economy and company profits and vice-versa.

In the post-reform period, India stands as an economy that is rapidly modernising, globalising and growing. India is poised as a fast growing emerging market economy in the face of the turmoil and pessimism in the rest of the world. The resilience shown by India comes from the strong macroeconomic fundamentals. India has weathered the storms of the many financial market crisis with great strength and stability. The

household sector is coming to prominence with impressive contribution in the national pool of savings. Rising investment levels and improved productivity are the engines driving growth. The strong institutional and macroeconomic policy framework in India is further complemented by the gains from trade and global financial integration.

Over the years, the Indian capital market has experienced a significant structural transformation in that it now compares well with those in developed markets. The regulatory and supervisory structure is robust with most of the power for regulating the capital market having been vested with the Securities Exchange Board of India (SEBI). Globalization and financial sector reforms in India have ushered in a sea change in the financial architecture of the economy. In the contemporary scenario, the activities in the financial markets and their relationships with the real sector have assumed significant importance. Since the inception of the financial sector reforms in the early 1990's, the implementation of various reform measures including a number of structural and institutional changes in the different segments of the financial markets has brought a dramatic change in the functioning of the financial sector of the economy.

2. DEFINITIONS AND MEANING OF CAPITAL MARKET

The capital market is a place where people buy and sell securities. Securities are bundle of rights sold to the public by companies, authorities or institutions and which are traded in the capital market.

Capital market is defined as "The market for relatively long-term financial instruments. It consists of gilt edged market and the industrial securities market. The gilt edged market refers to the market for government and semi-government securities backed by the RBI. The securities traded in this market are stable in value and are much sought after by banks and other institutions".

The capital market is the market for securities, where companies and governments can raise long-term funds. The capital market concerns two broad types of securities traded, debt and equity. In the Capital Market corporate equity and loner-term debt securities those maturing in more than one year are issued and traded.

2.1 Supply in Capital Market

The supply in this market comes from savings from different sectors of the economy. These savings accrue from: Individuals, Corporates, Governments, and Foreign countries, Banks, Provident Funds and Financial Institutions.

2.2 Capital Market Instruments

The various capital market instruments used for raising resources are: Preference shares, Equity shares, Non-voting equity shares, Cumulative convertible preference shares, Company fixed deposits, Warrants, Debentures, Bonds, Mutual funds, Derivatives, Commodities and Currency exchange.

2.3 Types of Capital Market

The Capital Market comprises the primary capital market and secondary capital market.

2.3.1 Primary Capital Market

The primary capital market is a market for new or fresh issues. It deals with the long-term flow of fund from the surplus sector to the government and corporate sector through primary issues. Primary issues of the corporate sector lead to capital formation. The Primary market for securities is the new issues market which brings together the "supply and demand" or "sources and uses" for new capital funds. Typically, a company engages an investment banker to underwrite the offering and a corporate lawyer to assist in the drafting of the prospectus. The sale of stock is regulated by authorities of financial supervision and where relevant by a stock exchange. It is usually a requirement that

disclosure of the financial situation and prospects of a company be made to prospective investors. A follow on public offering/ Further Issue is when an already listed company makes either a fresh issue of securities to the public or an offer for sale to the public, through an offer document.

2.3.2 Secondary Capital Market

The secondary market also called "aftermarket" is the financial market for trading of securities that have already been issued in initial private or public offering. Stock exchanges are examples of secondary markets. Secondary market is also called share market. Share market includes exchange of those securities which are already sold and listed in the Primary market. Any transaction in the share market can be executed by the members of the exchange following the rules and regulations of the SEBI. If any normal investor wants to buy or sell any security then he or she will have to contact with a member (broker) of the exchange. The brokers alone can trade in the Exchange and are entitled to a certain brokerage. An equity instrument being an external fund provides an all-time market while a debt instrument, with a defined maturity period, is traded at the secondary market till maturity. Unlike primary issues in the primary market which result in capital formulation the secondary market facilitates only liquidity and marketability of outstanding debt and equity instruments. The secondary market also provides instant valuation of securities made possible by changes in the internal environment that is, company wide and industry wide facilities, the measurement of the cost of capital and rate of return of economic entities at the micro level. The Indian secondary capital market can be classified as:

1. Secondary capital market for corporate and financial intermediaries.
2. Secondary capital market for government securities and public sector bonds.

3. DEPOSITORY SYSTEM OF INDIA

A Depository Participant (DP), described as an agent of the depository, is an intermediary between the depository and the investors. The relationship between the DPs and the depository is governed by an agreement made between the two under the Depositories Act, 1996. In a strictly legal sense, a DP is an entity which is registered as such with SEBI under the provisions of the SEBI Act. As per the provisions of this Act, a DP can offer depository related services only after obtaining a certificate of registration from SEBI. A depository is an organisation which assists in the allotment and transfer of securities and securities lending by using electronic form through a registered depository participant. The shares in a depository are held in the electronic form and the depository system revolves around the concept of paper less or scrip less trading i.e. electronic. An effective and fully developed securities depository system is essential for maintaining and enhancing the market efficiency which is one of the core characteristics of a mature capital market. The depository system provides a wide range of service, as primary market services, secondary market services and ancillary services. A depository can be compared to a bank. A depository holds securities of investors in electronic form. Besides holding securities, a depository also provides services related to transactions in securities.

There is a two Depository system in India as below:

3.1 National Securities Depository LTD. (NSDL)

The NSDL, the first depository in India was promoted by three premier institutions in India, i.e. Industrial Development Bank of India, UTI and NSE. The NSDL started from November 8, 1996. The NSDL is a public limited company framed under the companies Act 1956 with a paid up capital of Rs. 105 crore, The NSDL carries out its operations through participants

and the clearing corporation of the stock exchange, with participants acting as market intermediaries through whom NSDL interacts with the investors and clearing members. NSDL performs the following functions through depository participants:

1. Enables the surrender and withdrawal of securities to and from the depository (dematerialisation and re-materialisation).
2. Maintains investor holdings in the electronic form
3. Effects settlement of securities traded on the exchanges
4. Carries out settlement of trades not done on the stock exchange (off-market trades)
5. Transfer of securities.
6. Pledging/ hypothecation of dematerialised securities
7. Electronic credit in public offerings of companies or corporate actions
8. Receipt of non-cash corporate benefits like bonus rights, etc. in electronic form and
9. Stock Lending and Borrowing.

3.2 Central Depository Services Ltd. (CDSL)

CDSL was promoted by Bombay Stock Exchange Limited (BSE) jointly with leading banks such as State Bank of India, Bank of India, Bank of Baroda, HDFC Bank, Standard Chartered Bank, Union Bank of India and Centurion Bank. CDSL was setup with the objective of providing convenient, dependable and secure depository services at affordable cost to all market participants. It commenced its operation on March 22, 1999. BSE has 45% stake in CDSL while the banks have a 55% stake. CDSL has been preferred platform by the government of India for carrying out actual share transactions. PSUs disinvestment have been done through CDSL system. The centralized system of CDSL keeps a watch on every transaction. All leading stock exchanges have established connectivity with the CDSL. CDSL's demat services are extended through its agents called Depository Participants (DP). The DP is the link between the investor and CDSL. An investor who opens a demat account with a DP can utilise the services offered by CDSL. While the DP processes the instructions of the investor, the account and records thereof is maintained with CDSL. A DP is thus a "service centre" for the investor. CDSL's system is based on centralised database architecture with on-line connectivity with DPs. Because of this centralised architecture, the cost for setting up a DP outfit under CDSL system is significantly lower. Similarly, the recurring costs to be incurred by a CDSL-DP in terms of maintaining back-ups and the related data storage are minimal. The centralised architecture also allows CDSL-DP to make available to the investors a to-the-minute status of their account and transactions. CDSL-DPs can also setup branches with direct electronic connectivity with CDSL. CDSL perform a wide range of securities related functions through DPs. The services of Depository participants are:

1. To record and maintenance of individual investors beneficial holding in an electronic form.
2. Dematerialisations of physical securities and Rematerialisations of securities.
3. To give facility for locking of investor accounts.
4. To give facility for pledge and hypothecation of securities.
5. To make settlement of trades in electronic shares.
6. To issue a form for public offerings.

4. EXCHANGES IN INDIA

The stock exchanges are important players of the capital market. They are the citadel of capital and fortress of finance. They are the platform of trading in securities and as such they assist and control the buying and selling of securities. Thus, stock exchanges constitute of a market where securities issued by the central and state

governments, public bodies and joint stock companies are traded. There are mainly four stock exchanges in India:

1. Bombay Stock Exchange (BSE)
2. National Stock Exchange (NSE)
3. The Over The Counter Exchange of India (OTCEI)
4. Regional Stock Exchanges.

4.1 Indexes of BSE

1. **SENSEX:** BSE SENSEX or Bombay Stock Exchange Sensitive Index is a value-weighted index composed of 30 stocks started in April, 1984. It consists of the 30 largest and most actively traded stocks, representative of various sectors, on the Bombay Stock Exchange. These companies account for around one-fifth of the market capitalization of the BSE. At irregular intervals, the Bombay Stock Exchange (BSE) authorities review and modify its composition to make sure it reflects current market conditions. The index is calculated based on a free-float capitalization method; a variation of the market cap method. Instead of using a company's outstanding shares it uses its float, or shares that are readily available for trading. The free-float method, therefore, does not include restricted stocks, such as those held by company insiders.
2. **BSE National Index:** This made is trade up of 100 scrips with 1982–84 as the base year. The special feature of this index is that it includes prices of scrips in other major Regional stock exchanges i.e. Delhi, Calcutta, Ahmedabad, Madras, Bangalore etc. The average price of the scrip is taken for the compilation of the index.
3. **BSE 200:** It was introduced in May, 1994 with 1989–90 as the base year. This index consists of equity shares of 200 companies selected on the basis of market capitalisation, volume of turnover and strength of the company's fundamentals. It comprises of scrips of both specified and non-specified groups. The average price of the scrip is taken for the compilation of the index.
4. **Dollex:** Dollex is nothing but BSE-200 Dollar values so that may be useful to foreign investors. This index consists of equity shares of 200 companies selected on the basis of market capitalisation, volume of turnover and strength of the company's fundamentals. It comprises of scrips of both specified and non-specified groups. In Dollex, the BSE 200 is modified by dividing the current rupee market value by rupee-dollar conversion rates
5. **BSE 500:** It was introduced in 1999 with the base year 1999 itself. It is treated to be a standard index covering all Sections of the economy as well as the major part of capitalization. This index consists of equity shares of 500 companies selected on the basis of market capitalisation, volume of turnover and strength of the company's fundamentals. The average price of the scrip is taken for the compilation of the index.

4.2 Indexes of NSE

The common and popular name of the NSE index in CNX index. All NSE indexes are prepared by the Indian Index Services and products Ltd. (IISL) which is a joint venture of NSE and CRISIL and S & P. The CNX stands for following: C = CRISIL N = NSE X = Index. The letters S & P with any index indicates that it is supported by standard and poor.

1. **S&P CNX NIFTY:** It is popular index of NSE. It was introduced in April 96 with 95 as the base year. It comprises of a well-diversified 50 stock index accounting for 23 sectors of the economy of the total traded value of NIFTY stocks with about 59% of the total market capitalization. The average price of the scrip is taken for the compilation of the index.

2. **S&P CNX DIFTY:** It is popular index of NSE. It is nothing but S & P CNX NIFTY expressed in dollars and useful to foreign investors. It is computed at on line rupee, Dollar exchange rate.
3. **CNX NIFTY Junior:** This index was launched in December 1996 and S&P CNX NIFTY and CNX NIFTY Junior together account for 100 most liquid stocks in India. The average price of the scrip is taken for the compilation of the index. The two indexes are synchronized so that they will always operate as disjoint sets in the sense that a stock will never appear in both indexes at the same time.
4. **S&P CNX 500 Equity Index:** It comprises of 500 stock covering 79 companies. It is purely a market capitalization weighted index. It covers 97% of the total turnover in BSE and 73% of the total market capitalization.
5. **CNX Midcap 200 Index:** As the name implies, it is the index for the stock of mid cap companies, covering industries having market capitalization between Rs. 150 crores and Rs. 1000 crores.
6. **CNX Segment Indexes:** This index reflects the stock market performance of the various segments of the Indian corporate sector like multinationals, PSUs etc…
7. **NSE Government Security Index:** This index is meant for all government of India bonds issued after April 1992 but redeemable after 1997. The base date of the Index is 1st January, 1997. This index is calculated on daily basis with the help of market capitalization.

5. BUSINESS OPERATION/ PROCESSES

5.1 Primary Market

The key players in the primary market are:

1. Issuers
2. Merchant Bankers
3. Underwriters
4. Bankers to an Issue
5. Portfolio Managers
6. Debenture Trustees
7. Registrar to an Issue and Shares Transfer Agents

5.2 Secondary Market

The key entities in the secondary market are:

1. Stock Exchanges
2. Stock Brokers
3. Sub brokers

5.3 Mutual Funds and Institutional Investors

The key entities in this area are:

1. Mutual Funds
2. Foreign Institutional Investors
3. Financial Institutions
4. Venture Capital Funds
5. Collective Investment Schemes

5.4 The Other Players in the Capital Market are

1. Depositories
2. Depository participants
3. Custodians
4. Overseas Corporate Bodies

5.5 Different Types of Instruments

5.5.1 Stocks

They represent ownership interest in the company. Since the stocks refer to the equitable ownership in the company, they are also referred as equities. Par value is the notional face value of the shares which a company issues to investors. A company could, however, issue shares above

par value, which means at a premium, if it meets the profitability criteria laid down by Securities and Exchange Board of India (SEBI). SEBI has dispensed with the system of a fixed par value of Rs. 10 or Rs. 100 by withdrawing the 1983 government circular. However, this freedom of pricing is available only to those companies whose shares have been dematerialised.

5.5.2 Bonds

This instrument is issued by a corporation or a government, recognizing a debt to the bondholder. The bond pays interest at fixed or variable rate and has a fixed maturity. Bonds do not represent ownership in the company. The maturity of the bonds varies from a year to 30 years and they are classified accordingly as short, intermediate and long term.

Debenture includes debenture stock, bonds and other securities of a company, whether constituting a charge on the assets of the company, or not. Companies issue fully or partly convertible debentures and convert either in full or in part the face value of the debentures into equity shares either at par or at a premium. The non-convertible portion is redeemed at the end of the specified period. The secured and non-secured debentures refer to the fact whether the asset has been mortgaged by the company in favour of the debenture holders.

A bond is an instrument under seal whereby one person binds himself to another for the payment of a specified sum of money either immediately or at a fixed future date. Zero coupon implies that the interest on the bond is zero. The deep discount bonds are issued at the discount to the maturity value. i.e. a bond, which is maturing 10 years later for Rs. 1,00,000, would be issued now at Rs. 40,000 only while the face value of the bond would be Rs. 1,00,000.

The yield of bonds is frequently mentioned as "basis points". This is the standard unit of measurement for the specification not only of bond yields, but of movements in interest rates and foreign exchange rates. One basis point is equal to one-hundredth of a Per cent (0.01%). Thus the difference between bonds yielding 10.5% and 11.5% annually is 100 basis points.

5.5.3 Securities

The fixed income securities are:

1. Debentures
2. Preference shares
3. Government securities and bonds
4. Debt instruments
5. The variable income securities are-
6. Equity shares
7. Money Market instruments

The following entities are connected to the process of the issue of the shares:

1. Company or the Issuer
2. Investor
3. Investors' stock invest banker
4. Merchant Banker as the Lead Manager
5. SEBI; Registrar of Companies; Stock Exchange and Ministry of Finance, Stock Exchange Division
6. Registrar to the Issue
7. Underwriter to the Issue
8. Adviser to the Issue
9. Advertising Agency
10. Printer of stationery, forms, share certificates, refund orders, etc.
11. Banker to the Issue–Collecting branch; controlling branch; refunds
12. Bank of the Issuer
13. Brokers
14. Depository and Depository Participant.

5.5.4 Public Issue

Offering securities to the public for subscription by issuing prospectus.

5.5.5 Private Placement

Procuring subscription by offering securities to specific and known persons (Section 67(3) of the Companies Act)

5.5.6 Rights Issue

Offering securities to the existing equity shareholders of the company (Section 81 of the Companies Act)

5.5.7 Offer for Sale

Offering securities by promoters or group of persons holding substantial shares of a company to the public for subscription especially in the case of closely held public companies.

5.5.8 Bonus Issue

Sharing the profits with the existing shareholders by giving additional shares without any payment.

5.5.9 Preferential Issue

To the promoters or any other specified class of investor.

5.5.10 Firm Allotment

To special class, e.g., Employees (ESOP), NRIs, etc.

5.5.11 Public Issue

The process of planning the public issue begins with an identification of a suitable project and the fund requirements. The debt to equity ratio is worked out and then it is decided as to what quantity of funds are required to be sourced from the market.

Unlisted company cannot make a public issue of shares unless it has a track record of distributable profits in 3 out of 5 immediately preceding years and a pre-issue net-worth of not less than Rs. 1 crore in 3 out of 5 preceding years and the minimum net-worth met during the immediately preceding 2 years. If the unlisted company does not satisfy these conditions then the project of this unlisted company has to be appraised by a bank or financial institution and not less than 10% of the project cost has to be financed by the appraising bank either by loan or equity and the said contribution has to be brought in by the bank at least a day before the public issue is opened.

A Public limited company is required to appoint a SEBI registered Merchant Banker, which appraises the issue as per the extant regulations and files a draft prospectus with SEBI. The Draft prospectus with the SEBI has to be filed at least 21 days prior to the filing of the prospectus with the ROC.

The issuer company can mention a price band of 20% (cap in the price band should not be more than 20% of the floor price) in the offer documents filed with SEBI. The actual price can be determined at a later date before the document is actually filed with the ROC. The final offer document that goes to the public will contain only a single offer price. The promoter then identifies the suitable dates on which the company proposes to approach the public for application. Adequate publicity and road shows are organised to generate interest in the company, so that the issue is fully subscribed at the earliest closing day (3rd day from the day the issue is opened).

Underwriter is an entity, usually a merchant banker or a broker, which undertakes to subscribe the unsubscribed portion of the public issue. The practice of issuing shares at a price below the public issue price prior to the public issue, *prima facie*, gives an advantage to such allottees. SEBI has now put in a lock in for such entire allotment.

5.5.12 Rights Renunciation

The renunciation of rights is another method for subscribing to the shares of a company. Any share holder of the company after receiving an offer from the company to subscribe to its rights issue, can dispose of the rights form and receive payment. The investor, thus renounces his rights in favour of another investor who is interested in subscribing to the share of that company. The subsequent investor on receipt of this renunciation form applies to the company for the shares and is allotted the same. Through this mode, the second investor has become the share holder of the company.

The tax angle in this relates to capital gains on the sale of the rights forms. The valuation of the same needs to be done on the basis of the value of the share in that period and the premium or discount at which the same is trading in the market during that period. The investigation could be of the actual investor who has renounced the same and whether the gains by way of premium charged have been reflected in the books of the said investor/ trader.

5.5.13 Book Building

Book building is a process used for marketing a public offer of equity shares of a company and is a common practice in most developed countries. Book building is a price discovery mechanism used by the corporates issuing securities, to discover the price of their securities. The mechanism also helps the small investors to subscribe to securities at a price, which is arrived at by a transparent process. This mechanism was introduced by SEBI in 1995, and initially was used mainly for the private placement of the debt securities. Book building is called so because it refers to the collection of bids from investors, which is based on an indicative price range. The issue price is fixed after the bid closing date.

A company planning an initial public offer (IPO) appoints a category-I merchant banker as a book runner. Initially, the company issues a draft prospectus which does not mention the price, but gives other details about the company with regard to issue size, past history and future plans among other mandatory disclosures. After a draft prospectus is filed with the Securities and Exchange Board of India (SEBI), a particular period is fixed as the bid period and the details of the issue are advertised. The book runner builds an order book, that is, collates the bids from various investors, which shows the demand for the shares of the company at various prices. For instance, a bidder may quote that he wants 50,000 shares at Rs. 500 while another may bid for 25,000 shares at Rs. 600. Prospective investors can revise their bids at any time during the bid period, that is, the quantity of shares or the bid price or any of the bid options. Usually, the bid must be for a minimum of 500 equity shares and in multiples of 100 equity shares thereafter. The book runner appoints a syndicate member, a registered intermediary who garners subscription and underwrites the issue. On closure of the book, the quantum of shares ordered and the respective prices offered are known. The price discovery is a function of demand at various prices, and involves negotiations between those involved in the issue. The book runner and the company conclude the pricing and decide the allocation to each syndicate member. The bidder has to pay the maximum bid price at the time of bidding based on the highest bidding option of the bidder. The bidder has the option to make different bids like quoting a lower price for higher number of shares or a higher price for lower number of shares, etc. The syndicate member may waive the payment of bid price at the time of bidding. In such cases, the issue price may be paid later to the syndicate member within four days of confirmation of allocation. Where a bidder has been allocated lesser number of shares than he or she had bid for, the excess amount paid on bidding, if any, will be refunded to such bidder.

Unlike international markets, India has a large number of retail investors who actively participate

in IPOs by the companies. Internationally, the most active investors are the mutual funds and other institutional investors, hence the entire issue is book built. But in India, 25 per cent of the issue has to be offered to the general public.

Unlike in book-building, IPOs are usually marketed at a fixed price. Here the demand cannot be anticipated by the merchant banker and only after the issue is closed do we know whether the issue has achieved the minimum levels of subscription. In book building, the demand for the shares is known before the issue closes. In fact, if there is not much demand, the issue may be deferred.

A corporate can come with 75% book building (BB) issue or 100% BB. SEBI has directed that the procedure to be followed in each of the above cases shall be as under:

Seventy five Per cent Book Building is an issue of securities to the public through a prospectus. The Issuer Company has the option of reserving the securities for firm allotment or issuing the securities through the BB process. The issue through BB process is separately identified as 'placement portion' category in the prospectus (75%). The securities available to the public are identified as 'net offer to the public' (25%). The public offer is mandatory underwritten.

One of the lead managers is nominated as the Book runner (BR) and his name is mentioned in the prospectus. The BR circulates the copy of the prospectus to institutional buyers. He also gives the prospectus to intermediaries who are willing to underwrite the issue. The draft prospectus indicates the price band within which the issue has been offered to the public.

6. MERCHANT BANKERS

Merchant Banker is an entity, which engages itself in the business of issue management. SEBI Act, 1992, defines a Merchant Banker as " a person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering corporate advisory service in relation to such issue management". A merchant banker is prohibited from indulging in activities pertaining to fund based activities.

6.1 Lead Manager

The main activities of the Lead Manager are as under:

1. Capital structure and composition of Debt to equity norms, type of instrument
2. Drafting and designing of the offer document, etc.
3. Completion of the prescribed formalities in compliance with the various statutes
4. Marketing of the issue and preparation thereof
5. Selection of the other intermediaries
6. Follow up with the banks and complete the formalities
7. All post-issue activities

SEBI has prescribed that the MB shall file six monthly reports with SEBI about its activities and accounts. SEBI also collects fees from the MB. However, unlike the case of Stock Brokers, this is not connected to the volume of turnover that the MB generates but are a fixed slab. SEBI has also prescribed that the books of accounts would be maintained which can be inspected by SEBI and that they should be maintained at the address of registration only.

6.2 Registrar to the Issue and Share Transfer Agents

Registrar to the issue undertakes activities relating to the subscription of the issue, allotment and refund of the money to the unsuccessful applicant.

6.3 Underwriters

Underwriters agree to subscribe to the issue in the event of the investors not subscribing to the offered securities. These entities are also registered with SEBI and at the time of registration they should have a capital adequacy of at least Rs. 20 lakh and maintain the same till the currency of the registration. Merchant Bankers and Brokers could be underwriters without any separate registration. The services of the Underwriters are akin to assurance service.

6.4 Bankers to the Issue

Bankers to the issue engage in the activity of acceptance of application along with application money, their realisation and refund of the application money to the unsuccessful applicant.

6.5 Portfolio Managers

This activity pertains to the management of portfolio for others by professional investment managers. A portfolio manager is prohibited from giving assured returns to an investor.

6.6 Custodial Services

Custodial services simplify and expedite transactions involving transfer of securities. The services provided by the custodian includes safe keeping of securities, management of documents of title, etc. The custodian charges fees for the services offered which are based on the number of securities handled by the custodian. SHCIL is offering custodial services to UTI and the Insurance companies including LIC, GIC, etc.., many of the foreign banks including CITI and HSBC are offering custodial services to the FIIs.

6.7 Credit Rating

It is an expression of an opinion through symbols, about the credit quality of the issuer of securities with reference to a particular instrument. It is representative in nature and does not recommend to deal in any manner in the security. The credit rating agencies measure risk associated with a particular instrument so that the investor can take an informed decision. SEBI has issued regulations regarding the Credit Rating Agencies. These regulations are called SEBI (Credit Rating Agencies) Regulations, 1999.

The credit rating is particularly insisted upon for the debt instruments because the debt instruments are long term instruments and the exit route available to the equity share holders of selling the shares in the market is generally unavailable to the debenture holders and hence the same is insisted upon for the debt instruments.

6.8 Secondary Market

All transactions carried out through or in any of the recognised Stock Exchange constitute Secondary Market. The securities market provides for the three major functions in the capital markets. These are as under:

a. Capital raising by bringing together the investor, issuer and the intermediary

b. Price discovery mechanism for the value of the investments

c. Exit mechanism for the investors to liquidate their holdings.

7. TRADING IN THE STOCK MARKET

Securities Contracts (Regulations) Act, 1956, defines Stock Exchange as "Stock Exchange is an association, organisation or body of individuals whether incorporated or not, established for the purpose of assisting, regulating or controlling the business in buying, selling and dealing in securities".

The trading of the stock is done on the stock markets. The stock exchange offers listed securities for open auctions market where buyer and sellers from all over the country meet on terms of perfect equality and evolve a competitive market price. These dealings take place subject to a well-defined code of by-laws and regulations

and full and prompt publicity is given to every transaction. The markets are developed to provide efficient and transparent trading to the investors so that they get the best value for their shares. These exchanges are trading on-line that has replaced the age-old practice of trading ring and the open out cry system of trading.

The Stock Exchange Rules and by-laws prescribe the manner in which the stock exchange shall run and the Regulations provide for various formats for issue of contract notes etc. In addition, there are Over the Counter Exchange of India and the Interconnected Stock Exchange. Both these exchanges are having electronic trading facilities. The OTCEI was established to provide a route for small cap companies to resource funding and then list the shares, so that an exit route is available to the investor. Modern concepts were introduced in OTCEI like Market Maker (for providing two way quotes for a given security, so that liquidity is maintained in that particular scrip) and Safety Net (the lead manager was required to buy the shares offered at a particular price for a given time frame, so that the investor's who are not keen about the shares are having an exit option).

In the on-line transactions, there is no 'ring', nor any 'sauda blocks'; in fact there is no movement of the broker from his office. The on-line transactions are done on the computer, wherein, on the computer screen, the details of the shares available for sell/ buy and the quantity and rate is mentioned. The deal is struck on the computer itself, without the either party knowing the counter party. The transaction is confirmed immediately. The on line system is transparent and provides a fair rate to the investor. The transactions and the order placed are also time stamped so that there cannot be any allegation of foul play.

7.1 Stock Exchange

The Stock Exchanges are entities which regulate the dealing of the brokers registered with them and operating within a specified area. The Exchanges were earlier recognised by the Stock Exchange Division of Ministry of Finance and now by SEBI.

7.2 Brokers

The member of stock exchange is termed as a Broker. This entity by virtue of its holding the stock exchange membership is entitled to deal with the clients and on behalf of them in securities on the exchange. The membership of the exchange could be given to individuals, Corporates and partnership firms (partnership could be between the members of the exchange or between near relatives as defined in the exchange bylaws). The exchange requires the person interested in taking the membership of the exchange to take an exam. He is also required to have high capital so that the member secures the exchange in case of default. The exchange also takes from him adequate capital in compliance with the SEBI Base minimum capital norms, which could be in the form of cash and bank guarantee. SEBI registration is required for a broker to start his business.

7.3 Sub-Brokers

The brokers usually engage some other persons at various centres in India to solicit the business or clients; these persons are called as sub-brokers. These Sub-brokers are also registered with SEBI. The sub-brokers are identified with reference to the main Broker. In essence, they are only clients of a broker.

7.4 Broker, Speculator and Trader

The broker may do business for his own self and for a client. The trades of the client are clearly marked. The trades that the broker does for himself could be for doing jobbing, i.e. buying and selling particular scrip in order to gain from the price difference. However, this action is with short term view only for exploiting any opportunity by way of arbitrage and is essentially speculative in

nature. Doing this also provides liquidity in that counter. This trading is the same as day trading. However, day trading term is used for trades by investor, while when the broker does the same it is known as jobbing. The own trades could be for speculation purposes also; i.e. the trades in particular scrip could be over a long term basis for benefit from a substantial price movement.

Client identification-Client ID-The uniform Client ID code is generated by the broker with whom investors transacts. The broker generates the number on the basis of PAN of the Income-tax Department.

7.5 Trading

The trading takes place in the exchange for listed securities as well as permitted securities. The listed securities are the one, which are listed with the exchange. The permitted securities are those securities that are not listed in that exchange, but with some other exchange. The other rules and regulations for the trading continue to be the same for both.

7.6 Settlement Cycle and Trading Hours

Equity spot markets follow a T+2 rolling settlement. This means that any trade taking place on Monday, gets settled by Wednesday. All trading on stock exchanges takes place between 9:15 am and 3:30 pm, Indian Standard Time (+ 5.5 hours GMT), Monday through Friday. Delivery of shares must be made in dematerialized form, and each exchange has its own clearing house, which assumes all settlement risk, by serving as a central counterparty.

7.7 Trading Procedure

a. Placing of the order by the client. This order can be a limit order (transaction at a fixed price) or best market order (transaction at the best available market price) or open order (transaction at any price at the time of the placing of the order).

b. Entry in the order book by the broker and time stamping of the order.

c. Execution of the order after it is placed in the system of the exchange.

d. Computer generated confirmation of the execution of the transaction and generation of the contract note.

e. Entry in the settlement register and the client register

f. Bill or delivery slip

g. Actual delivery of the shares or payment by the client to the broker

h. Entry in the client ledger and scrip ledger

i. Payment

At the turn of the century trading has undergone a sea change. The trading in all the exchanges is now through the electronic trading systems. The popular version of the system is the Bombay Stock Exchange on-line Trading System (BOLT). This system receives quotes from the investors, jobbers, etc. and is matched on the basis of the logic specified for each system. The screen of the broker would display the following features-

Best Bid (sell prices) and Offer prices (purchase)

Depth of the Market (number of shares available for trading) and at what prices

Market view window for information of each stock listed including the best five buy and sell prices and the quantity available, the opening, high, low and previous day's closing price, the last traded price and the quantity, the total number of trades and the total number of and value of the shares traded.

National Stock Exchange for Automated Trading System (NEAT) is an order driven system and has no intermediaries such as jobber to induce orders. The orders received through the system are matched and executed on a price time priority basis as per the logic of the system.

7.8 Volumes Transacted in the Exchanges

The main activity of trading is concentrated in NSE and BSE. These two exchanges have introduced derivative trading. The market capitalization to GDP ratio of BSE-listed firms is above 100 Per cent, based on the four quarter trailing nominal GDP of the economy. As on Jan. 23, 2018 the market capitalization of BSE listed firms stood at Rs 156.56 lakh crore, which is 103 Per cent of the four quarter trailing nominal GDP of the country. If compared to the advance estimates for nominal GDP in FY18 released by the Central Statistical Office, the market cap to GDP ratio stands at 94 Per cent.

The market cap to GDP ratio is a reflection of the valuation of listed enterprises *vis-a-vis* the value of goods and services produced in an economy. In theory, equity valuations should be linked to earnings expectations, which in turn are linked to the underlying economy. The indicator was popularized by the likes of Warren Buffet, who cited it as a key metric he watches. However, not everyone believes that the indicator is relevant to India. Some argue that listed enterprises in India may represent a smaller subset of industries where growth is higher than in the broader economy.

Still, data from Bloomberg shows that the market cap to GDP ratio is above 100 per cent for the first time since 2007. Back then, market cap to GDP had hit a 146 per cent. The indicator is not strictly comparable over time since the set of listed companies continues to change as new firms enter the market and some exit.

7.9 Settlement System

Settlement is the netting of transactions and the actual payment and delivery of shares and the payment. There are two types of systems used in the settlement of the exchange transactions:

a. Accounting Period System.

b. Rolling Settlement System.

7.9.1 Accounting Period System

In the accounting period system, there is batch wise settlement. The transactions entered over the entire period of trading are aggregated and the net position in each scrip broker wise is worked out, which is then communicated to the brokers for settlement. The Indian Exchanges follow this method for settlement.

In the rolling settlement, each day is treated as a separate trading period and that day's transactions are netted and communicated to respective brokers for settlement after 3, 5 or more days. This system is commonly called as 'T + the number of days' settlement system. It is practiced mostly in developed countries.

The clearing house of the exchange is the repository of the entire information pertaining to the transaction from the exchange point of view (the exchange does not recognise the position of the client but only of its trading member). The clearing house does netting of the transactions every day and the net outstanding position could be long and/ or short for a particular scrip. This position is also netted for each day of the trading cycle and then the gross net position is prepared which is communicated to the concerned brokers for payment or delivery of the shares. The clearing house collects the amount and shares and the delivery of shares is given to the concerned parties. The broker passes this in turn on to the concerned client.

7.9.2 Rolling Settlement

Currently, in India, in the T+2 settlement, sale proceeds of transactions done on the first trading day are available on the 3rd day.

7.9.3 Contract Notes

A member can do the trading in the exchange on behalf of client or on own account (principal). If the member is dealing as a broker then he issues a contract note and the brokerage is mentioned separately on the contract note. The contract note is issued in the Type A. On the contrary,

when the member trades on own account, no brokerage is charged and the contract notes are issued in Type B. The contract note also contains information about the service tax, client ID, trade confirmation and the time at which the trade was executed.

The sub-brokers are not authorised to issue contract notes and any such contract note issued by a sub-broker is illegal. The bills issued by a sub-broker, if registered with SEBI, would also contain the SEBI registration number. Any bills issued by an unregistered sub-broker are illegal.

If the transactions were put through the exchange mechanism, it would have the client ID, order confirmation number and the time of execution of the trade in the exchange. Hence, by verifying the above details from the contract note, it is easy to identify whether the transaction was routed through the system.

7.10 Day Trading

Many of the brokers and clients indulge in a game of buy and sell in particular scrip during the entire trading session. This is only to gain out of the small price movement that takes place during the day. This is also with the intention to avoid paying margin, as any net outstanding position during the day is liable for paying the daily margin and the investor would end up blocking his money till the settlement is cleared. This is also done to avoid the risk of bad delivery or stolen shares or fraudulent shares in the market by a client who has ended with in a position of giving delivery. To avoid this risk, the brokers direct the clients to end up with a nil net position.

In day trading, the brokers also do not loso anything, as the investor would end up with nil net position and pay brokerage. He may gain or lose during the trading done in the day. The brokers in order to encourage this business usually charge less brokerage on the squaring up transaction. The broker gains out of the brokerage that he has earned during the day without having to pay any margin or end up giving physical delivery or receive the delivery. In fact the brokers charge different brokerage for transactions that result in delivery. Cess paid by the brokers.

The exchanges are charging a cess of 0.01% on the turnover of each broker. This is collected from the broker at the pay-in of each settlement cycle. The money so collected is used for the technological upgradation of the exchange. If the details of cess collected from the exchange are called and examined, the turnover of the broker can be calculated and verified with the turnover declared in the books of accounts. This cess has to be paid on transactions done for self and also on transactions that are reported to the exchange. This is in addition to the SEBI turnover fees.

7.11 Client Broker Relationship

The client broker relationship norms were introduced by SEBI in order to maintain transparency regarding the money of the clients *vis-à-vis* that of the broker. Also, without even the knowledge of the client, the money lying with the broker of the client would be used by the broker for badla financing and the returns without the client being aware of the same. The client-broker relationship norms ensure that the identity of each client is maintained and each client account is separate. The broker maintains the monies belonging to the clients in a separate bank account and his money is kept separately. With this step the transparency regarding the use of funds in the broker's office was ensured. The broker cannot put own order ahead of the pending order of the client. In case the same is done, the broker could be charged for front running.

The broker has to report the gross position of the trades to the exchange, including the ones which are netted in his office and which have no bearing on either the settlement of dues or that of the delivery. The client's position also has to be reported in gross and not net.

7.12 Clearing Corporations

In the securities industry, a clearing corporation is an organisation that simplifies the process of comparison, clearance and settlement between the broking firms after a trade is executed. Each participant submits their trade date to one central location, the clearing corporation, which in turn matches the buyers with their stated sellers and sellers with their stated buyers. In addition, the corporation may eventually put itself between the broking firms and/ or a depository thereby facilitating the actual delivery of the certificates.

Comparison is the process whereby two parties to a trade agree on the details of the executed trade. In the clearance process, the matched trades are locked and the final net position between the buyers and the seller in a particular security is finalized.

7.13 Arbitrage

Arbitrage could be defined as buying or selling of security in one exchange and reversing the position in the other exchange within a short time, to benefit from the price differential prevalent in the exchanges for different securities. An arbitrageur identifies the inefficiencies in the market and exploits the same and in the process makes the market efficient. Arbitrage involves buying and selling at the same time in different markets in a particular scrip and hence does not involve any view of the person in the price movement of the scrip. This position distinguishes an arbitrageur from other trader. Further, no person doing arbitrage will keep his position open. It is different from speculation in the sense that the speculator is taking a position in some security to make profit in the expectation of a favourable price movement in that scrip. While in arbitrage, there are two simultaneous opposite positions in the same scrip, so that the net position is zero, but there is gain due to the difference in the price of the particular scrip at different exchanges.

Commercially, arbitrage operation seeks to exploit price differential across markets dispersed over the country. The intention is to earn the price difference by matching the purchase or sale trade in one market with a counter transaction in another market to square off the first trade. Of course, it would happen that trades could overflow to the next day if they cannot be squared off on the same day. Depending upon whether market is bullish or bearish, first trade could be either a sale or a purchase. If it is sale, the counter trade (purchase) in another market covers the short sale.

7.14 Hedging

Hedging is normally resorted to protect from future losses on a position already taken. For the taxation, such transactions are not considered as speculation, If they are a part of the regular business of the assessee. In order to benefit, the assessee will have to show an existing open position in the market against which he has taken a counter position as a hedge.

A speculator is a person who is willing to assume the risks the hedger is trying to avoid. For taking these risks, the speculator expects the potential of high profits. The presence of speculators is absolutely necessary for a liquid and balanced market; otherwise there would be no one for hedgers to buy and sell their contracts to or from. The problem of identifying a hedger from a speculator is there, however, a hedger would have an existing position against which he is hedging, while a speculator would be entering the market afresh.

8. AREAS OF TAX EVASION AND ISSUES IN ASSESSMENTS

8.1 Bogus Purchase of Shares to Reduce Business Profit

Bogus purchase of shares means showing share purchase without actually purchasing shares. Since the actual purchase is not made, there can be no question of sale of such shares. Therefore,

those shares are carried to closing stocks. One of the most popular methods of valuation of closing stock-cost or market price, whichever is lower, is then followed by the assessee. The diminution in share price i.e. difference between purchase price of shares and the closing price of same shares is used to adjust the profit of other business carried by the assessee. This method is elaborated under Case Studies.

8.2 Investment *vs.* Trade

A perennial and contentious issue in scrutiny of stock brokers has been the booking of trading receipts as short term capital gains due to the differential rate of taxation.

However, the position has been settled with the *Circular No. 6/2016 (F.No. 225/12/2016-ITA-II), Dated 29/02/2016.* The circular states that where the assessee itself, irrespective of the period of holding of the listed shares and securities, opts to treat them as stock-in-trade, the income arising from transfer of such shares/ securities would be treated as its business income.

In respect of listed shares and securities held for a period of more than 12 months immediately preceding the date of its transfer, if the assessee desires to treat the income arising from the transfer thereof as Capital Gain, the same shall not be put to dispute by the Assessing Officer. However, this stand, once taken by the assessee in a particular Assessment Year, shall remain applicable in subsequent Assessment Years also.

The above shall not apply in respect of such transactions in shares/ securities where the genuineness of the transaction itself is questionable (Bogus LTCG/ Penny Stock cases). Thus, consistency of treatment of shares and securities as stock-in-trade/ investments should be invariably examined.

At times the stock-in-trade may be converted into investments to reap the benefits of lower or nil capital gains tax *vis-à-vis* business income. Any conversion of stock-in-trade into investments to reap the benefits of lower or nil capital gains tax vis-à-vis business income should be questioned and accordingly disallowed.

The AO should ask an explanation from the assessee for such conversion and disallow the same on the basis of following arguments:

i. *The intention of the assessee is mala fide in the sense that there is no cogent reason for such conversion other than evading tax.*

ii. *In the past, the loss on account of devaluation of closing stock-in-trade was always adjusted with the income as the valuation is done as per market value or cost whichever is lower. Now suddenly, assessee has changed its method of accounting from the stock-in-trade into investment, the loss of revenue on account of such conversion cannot be sustained on account of clever accounting.*

iii. *Stock-in-trade is not a capital asset. Simply changing the nomenclature cannot change the character of the asset. The shares which were carried in accounts book for so long as stock-in-trade cannot be rechristened as investment simply because one day, one changes its treatment.*

iv. *Such conversion is against the regularly followed method of accounting and under Section 145(3) the A.O is empowered to make the assessment in the manner provided in Section 144 of the I T Act.*

Also, there is a need to be vigilant against swapping of the shares held as stock-in-trade against those held as investments. Therefore, script-wise schedules of the stock-in-trade and investments should be invariably scrutinised *viz.* opening stock. Even if allowed, the *date on which the stock in trade is converted is the date*

on which that capital asset has taken birth. So the age of the asset should be counted from that date and accordingly indexation benefits should be allowed.

8.3 Payment of Sub-brokerage

As per Section 194H, TDS @ 5% is to be deducted on payment made in the nature of commission or brokerage. However, commission and brokerage on securities are specifically exempt from this provision.

Generally, 60–75% of the brokerage received by share brokers is shown as transferred to sub-brokers for bringing in the clients, as per the agreement entered. However, no TDS is deducted on the same, thereby giving rise to a situation akin to 'entry providing' wherein the broker may transfer 'x' amount through bank to the sub-broker and claim it as expense in the P&L A/c. At the same time, the sub-broker can withdraw and return the money, after deducting its commission.

The investigation should cover the following areas:

1. Incorporation of all the transactions done through a random sub-broker and the verification of the resulting commission with the terms & conditions as per the broker sub-broker agreement.
2. SEBI registration certificate of the sub-broker.
3. Proof of payment in bank statement with special attention to immediate withdrawal/ transfer by the sub-broker.
4. Offering of the income by the sub-broker in its return, especially in material cases can be verified by sending notice under Section 133(6).
5. Independent verification with clients in select, material cases.

Further, in scrutiny, an argument may be taken that what is claimed as sub-brokerage is actually a referral fee for introducing clients and hence it is not covered under the exception of Section 194H, which only exempts commission or brokerage on securities.

8.4 Taxation of Short Term Capital Gains @ 15% (Section 111)

A common occurrence in scrutiny of stock brokers is that profit on derivative transactions or non-equity mutual funds is offered as short term capital gains under Section 111A @ 15%. However, the Section is applicable for short term capital assets in equity segment on which STT is leviable.

Thus, the AO has to be vigilant against such a claim and needs to verify whether STT is paid, in case of funds, or not and whether it is a derivative transaction, in case of securities and accordingly allow/ disallow the claim. Since STT is leviable only in the case of equity oriented funds, all other debt funds, liquid funds, gold exchange traded funds etc.., should not be allowed the benefit under Section 111A of the Act.

8.5 STT Paid for Clients

Some stock brokers debit the STT paid by them on behalf of the clients from the brokerage charged and claim it as an expense under Section 37. At the same time, the clients also debit their books by the amount of brokerage paid, including the STT.

Therefore, from AY 2009–10, STT is allowed as a deduction as per Section 36(1)(xv) only if the income arising from such taxable security transaction is offered to tax under the head *'Profits and Gains from Business or Profession'*.

It should be noted that in case of such income being offered as Capital Gains, no deduction of STT paid is to be allowed.

Thus, till AY 2008–09 for all heads of income and from AY 2009–10 for capital gains, the STT is nothing but a payment of tax on the income of

the assessee and it is a well established principle that the payment of tax on income cannot be taken into account in the computation of income itself.

8.6 Marked to Market Losses (MTM)

Some stock brokers make a provision for notional loss on account of open contracts as on last day of the financial year and debit it in the P&L Account. Even though the assessees are debiting in the P&L A/c, provisioning for loss on equity index/ stock futures account, *the corresponding profits are ignored on the basis of prudence principle.*

Since the assessees only account for losses on MTM and not profits the decision of Hon'ble SC in *Woodward Governor* ((2009) 179 TAXMAN 326 is not applicable. In Woodward Governor the Hon'ble SC noted that,

> *" …..(d) The fact that the* department taxed the gains on fluctuation on the basis of accrual while disallowing the loss *is important and indicates the double standards adopted by the Department…".*

Since such is not the case with derivative losses, the same needs to be disallowed. Such losses being contingent in nature are not to be allowed. This view is reinforced by CBDT Instruction No. 03/2010, dated 23/03/2010, which clearly states that:

> *""Marked to Market" is in substance a methodology of assigning value to a position held in a financial instrument based on its market price on the closing day of the accounting or reporting record. Essentially, 'Marked to Market' is a concept under which financial instruments are valued at market rate so as to report their actual value on the reporting date. This is required from the point of view of transparent accounting practices for the benefit of the shareholders of the company and its other stakeholders. Where companies make such an adjustment through their Trading or Profit/ Loss Account, they book a corresponding loss (i.e the difference between the purchase price and the value as on the valuation date) in their accounts. This loss is a notional loss as no sale/ conclusion/ settlement of contract has taken place and the asset continues to be owned by the company.*
>
> A 'Marked to Market' loss may be given different accounting treatment by different assesses. Some may reflect such loss as a balance sheet item without making any corresponding adjustment in the Profit and Loss Account. Other may book the loss in the Profit and Loss Account which may result in the reduction of book profit. In cases where no sale or settlement has actually taken place and the loss on Marked to Market basis has resulted in reduction of book profits, such a notional loss would be contingent in nature and cannot be allowed to be set off against the taxable income. The same should therefore be added back for the purpose of computing the taxable income of an assessee."
>
> Hence, MTM loss is to be disallowed while scrutinizing tax returns of stock brokers.

8.7 Speculation Loss

A share trader does not distinguish between speculation loss and business loss. For him both are trades-one with delivery and the other without delivery. When he prepares his business P&L account, he finds the actual profit or loss. Then, he starts devising ways to save himself from financial burden which he feels is purely out of technical reasons. Add to this is the fact that method of evasion of tax in such situation is very easy to implement. He does not have to make any fake documents but a simple twist to computation of total income in a particular manner can save him tax.

Following two methods are being adopted by the share dealers.

8.7.1 Mix Speculation Loss with Trading Income

One needs to examine Form 10DB wherein code 3 pertains to non-delivery based sales (speculative).

8.7.2 Claiming Speculation Loss as Hedge Loss

One needs to examine whether the speculation was really to guard against losses in holdings of stocks & shares!!

Crucial check-*"whether the assessee had holdings in the same shares in which the speculation losses were incurred"*.

(Ref: CBDT Circular No 23D (XXXIX) dated 12/09/1960)

8.8 Dabba Transactions

These transactions are unreported and do not even appear in the books of the brokers. The chances of detecting and locating the dabba transactions are only through search or survey at the brokers' office. Many of the brokers even create a fictitious entity to put such transactions, in case of any verification.

8.9 Disallowances under Section 94(7)

Assessee should be asked to give date wise details of purchase and sale and dividend received along with record dates. Closer scrutiny of transactions in mutual fund schemes in which daily dividends are declared has to be made as in such cases the NAVs fluctuate on daily basis. In many such cases, disallowances under Section 94(7) have been attracted.

8.10 Closing Stock Undervaluation

The closing stock under valuation is a very common trick to reduce the profit. This method is applied in all kinds of business. But in case of shares, it can be applied very easily on account of sheer number of closing stock items. In many cases one may find the numbers of closing stock of shares as many as 400 or even 600 shares. If the A.O is not vigilant to check the market price of closing stock, tax evaders can quite easily reduce taxable profits without much effort.

8.11 Switch in Mutual Fund Schemes

Mutual funds allow switches to unit holders amongst the schemes of the funds. Verification of such switches should be made to see whether they amount to transfer within the meaning of Section 2(47) of the Act. The gains that arise on the switches that amount to transfer can be brought to tax as capital gains or business income as the case may be.

8.12 Benami Accounts

There have been instances, wherein benami accounts have been detected with the brokers and depositories. This has been found during the course of inspections conducted by the Depository of the various participants and also verifying bank details and sources of funds. These reports could give lot of clues for assessment of the concerned Depository participant.

8.13 Use of Mergers for Tax Evasion Restructuring

Merger or demerger of business is an important necessity. Therefore, many laws, including tax laws, that govern the business environment in the country recognize such need and incorporate relevant provisions to facilitate reorganization of business. Income-tax Act also contains benevolent provisions by which mergers & de-mergers exercise is made tax neutral. However, these benevolent provisions related to restructuring of business may be used for evading tax.

The assets transferred under merger and amalgamation are not treated as transfer under Section 2(47) of the I T Act. Therefore, when the shares are transferred to another company under scheme of amalgamation, such transfer, shall be out of purview of capital gains and even from newly inserted Section 56(2)(viia) of the I T Act. Therefore, assets transferred under merger

does not suffer either capital gains tax in hand of transferrers nor can be charged under Section 56(1) (viia) as Income from Other Sources" in the hands of the transferees.

8.14 Tax Evasion through Penny Stock

In Indian context, "Penny Stocks" are those shares which are purchased or sold in abysmally low quantity in stock exchange. The obvious reason for such low demand of shares of these companies among investors is their poor performance, business wise. Since there is no demand for those shares, market prices of such "Penny Stocks" are also quoted extremely low. Thus, Rs 10 face value penny shares may be quoted in a stock exchange at Re. 1.

Amendments in Section 112, introduction of Section 111A and insertion of Section 10(38) of the I T Act, all with the objective of encouraging investment, have made penny stocks and manipulation of their prices a medium for tax evasion.

The amendments are:

1. The tax rate in case of short term gains on shares was reduced to 10 % from A.Y. 2005/06 (insertion of Section 111A) which is now at 15%.
2. Section 10(36) introduced from 1/3/2003 by which long term capital gains was made exempt. But this was available to a very limited numbers of shares i.e BSE 500 listed companies.
3. Section 10(38) which totally exempted the long term capital gains on shares without any kind of condition other than that the shares should be transacted through recognized stock exchange and that securities transaction tax should be chargeable on such sale.

A few unscrupulous brokers in connivance with other brokers used the penny stocks listed in regional stock exchanges to misuse these three amendments brought in by the government to give fillip to the stock market. The result is that prices of the shares quoting at Re 1 increase, without any improvement in the performance of the company, at some point of time even to Rs. 100 or more leading to people making "huge tax free long term capital gains". After the shares prices have been manipulated to go up, the prices of those shares are hammered down to a very low value, usually towards the end of year. This facilitates artificial loss creation. These losses are purchased by many persons for lowering their other high business income.

Thus, a class of brokers with dubious character has started two new businesses through penny stocks manipulations; selling long term gains to persons having black money and selling losses to the business men who need it to reduce the profits of their real business.

Signs of manipulated penny stock investments: The observed characteristics of manipulated penny stock investments and resultant gains or losses are:

1. Most of these shares (penny stocks) may be listed on some regional stock exchanges only, like Calcutta, Kanpur, Magadh, Banglore etc...,
2. Most of the deals in these shares are done by only a group of select brokers of that stock exchange.
3. People who have never made any investment in shares are found investing in these shares.
4. Investors who get gains from these stocks get long term gains only.
5. The long term period is generally not more than one year and one month i.e. 13 months.
6. Investors who get losses get only either short term loss or business loss only
7. These "penny stock" companies do not perform to the extent that they become news for their business performance.

Therefore, in newspaper or TV or other media, they are never mentioned. Still, people from remote places make huge investments in these shares and get either huge LTCG or short term or business loss.

The typical modus operandi of the brokers' cartel involved in "penny stock" manipulation:

1. Unknown companies' shares having hardly any volume on the regional stock exchanges are taken up by the rogue brokers.
2. The price of the shares is then jacked up by process of circular trading. The circular trading is done among the closely related brokers by crisscross purchase and sale.
3. The shares are then sold to someone of the same cartel leading to huge tax free LTCG to the seller.
4. The purchaser of the shares at very high price will then sell within a few days only to someone else and claim huge short term/ business loss for adjusting against the gains of real business and reduce tax liability.
5. This way the unscrupulous brokers facilitate not only routing blackmoney as white money in the form of tax free long term gains, but also provide avenue for others to evade tax by adjusting artificially created loss.
6. All the operations are through normal and legal channels; the shares of the unknown company are purchased legally through stock exchange, they are held for twelve months in the demat account and sold after one year through stock exchange and the transfer of shares takes place from demat account.

The manipulation of penny stocks to provide entries of bogus LTCG and bogus losses has, over the years, become well organized. Before the actual transactions start taking place there are brokers in different towns who contact prospective clients and take paper booking for entries. The commission to be paid to the operators is decided at this stage but no money is paid. Once the booking is complete the operators have a reasonably good idea of how much LTCG is to be provided along with the break-up of individual beneficiaries. This data is essential to decide which penny stock or companies to use for the job and which beneficiary to buy how many shares.

Broadly speaking there are two types of companies which are used for penny stock manipulation:

i. An old already listed company, the entire shareholding of which is bought to provide LTCG entries. It is generally a dormant company with no business and with accumulated losses

ii. A new company which is floated just for the purpose of giving LTCG entries. Such new companies are often floated after the initial booking is complete and the capital base is decided keeping in mind the entries to be provided.

The entities involved in the transactions are:

i. **Syndicate Members:** They are the promoters of the Penny Stock companies who own the initial shareholding mostly in the name of paper companies either in a fresh IPO or purchased from the shareholders of a dormant company. They are usually a group of 4–5 individuals who are referred to as Syndicate Members and sometimes as Operators. Their nominees are the dummy directors of the Penny Stock companies. The whole operation is managed by them. They get commission income from the transactions. Their names however, seldom appear in the actual transactions.

ii. **The Brokers:** They are registered brokers through whom shares are traded both online and off-line. They are fully aware of the nature of transactions and get paid a commission over and above

their normal brokerage. Some of the big broking houses are also found to be indulging in such transactions, but mostly through sub-brokers. Even Calcutta Stock Exchange has registered itself as a broker with BSE and has given a large number of terminals to sub-brokers who were found to be dealing in this type of transactions. The brokers often compromise on KYC norms of the clients to help the Syndicate Members.

iii. **The Entry Operators:** They are individuals who control a large number of paper/ shell companies which are used for routing cash for the transactions as well as buying and selling shares during the process of price rigging. They work for commission to be paid by the Syndicate Members.

To cut cost, sometimes in smaller operations, the same group perform more than one function.

The transaction consist of three parts:

i. **Purchase of Shares by the Beneficiary:** In this the beneficiary is sold a fixed number of shares at a nominal rate. The price and the number of shares to be purchased are decided on the basis of the booking taken and the value up to which price would be rigged. This leg of the transaction mostly is off-line. This is done to save on STT as Section 10(38) of the IT Act places restriction of trading by payment of STT on sale of shares and not on purchase.

ii. **Price Rigging:** After the shares have been purchased by the beneficiaries, the syndicate members start rigging the price gradually through the brokers. In these transactions the volume is almost negligible. Two fixed brokers who are in league with the Syndicate buy shares at a fixed time and at a fixed price. These low volume transactions are managed through paper companies of entry operators.

iii. **Final Sale by the Beneficiary:** This is done after the beneficiary has already held the shares for one year. The period of holding may be a little more to match the amount of booking with the final rate. The beneficiary is contacted either by the Syndicate member or the Broker (Middle man) through whom the initial booking was done. The beneficiary provides the required amount of cash which is routed through some of the paper companies of the entry operator and is finally parked in one company which will buy the share from the beneficiary. The paper company issues cheque to the beneficiary.

The above mentioned methodology is referred to as Conventional Method. Another method which is also used quite often is called Merger Method. The methodology adopted in Merger Method is as under:

Merger Method: In this method the operators first form a Private Limited Company and the shares at par are allotted to beneficiary individuals. This private limited company is then amalgamated/ merged with a listed penny stock company by a High court order. Depending on the capital of the amalgamating and amalgamated companies, the investors are allotted stock of the listed companies in the same proportion. The capital of the Penny stock listed company and the private limited company are so arranged that the beneficiaries post-merger get shares of listed company in the ratio 1:1. Thus the investor gets equal number stocks of the listed company. The promoters of the listed penny stock companies run the syndicate. The brokers and the entry-operators through whose paper/ shell companies' cash is routed are merely commission agents. The penny stock listed company is such that though its capital base is small its market capitalisation is many times its capital base. This is managed again through small volume predetermined transactions amongst members of the syndicate. The prices of shares are thus manipulated to many times the face value. The investors hold the

shares of the penny stock listed company got as a result of merger for one year (statutory lock-in period for exemption under IT Act) and then sell it to one of the shell private limited companies of the operator. The investor thus makes a LTCG many times its original investment. The purchase consideration is again provided in cash by the investor which is laundered to the buyers account through a maze of shell companies as mentioned in the previous method.

8.15 Tax Evasion by Changing Client Codes

A facility provided by stock exchange for rectification of genuine error while trading for clients has become a tool for buying, selling and distributing the gains or loss.

Let us take an example. Mr X is promoter of many private limited companies. Let us say, his 3 companies have opened trading account with a broker who is member of NSE. Mr X wants a certain amount of loss in one company and another amount of gain in another company.

On a particular day, the broker finds one of his client, say Mr Y has earned profit on derivative trades, which he is ready to transfer to others for equivalent cash. So, broker will change the client code of original trade with the client code of the company of Mr X in which such trade was to be transferred. This is done after the trade hour upto the time allotted by NSE for rectification of order. Thus, the trade now appears legally as if done by company of Mr X and all the gains, which was actually of Mr Y, are transferred to company of Mr X. Mr X will pay cash equivalent of gains and the broker gets extra commission.

Similarly, if Mr X wants to reduce profit in one of his companies, he will simply buy loss from that broker who will substitute someone else loss to the company of Mr X.

Thus every step would seem as if the real trade was done by the substituted party. This kind of substitution of client code, which was allowed by stock exchange, for genuine purpose, has been abused by the unscrupulous brokers and their clients for creation/ manipulation of profits/ losses to reduce tax liability.

8.16 Algo Trading

Algorithmic trading (automated trading, black-box trading or simply algo-trading) is the process of using computers programed to follow a defined set of instructions (an algorithm) for placing a trade in order to generate profits at a speed and frequency that is impossible for a human trader. The defined sets of rules are based on timing, price, quantity or any mathematical model. Apart from profit opportunities for the trader, algo-trading makes markets more liquid and makes trading more systematic by ruling out the impact of human emotions on trading activities.

Suppose a trader follows these simple trade criteria:

1. Buy 50 shares of a stock when its 50-day moving average goes above the 200-day moving average. (A moving average is an average of past data points that smooths out day-to-day price fluctuations and thereby identifies trends.)
2. Sell shares of the stock when its 50-day moving average goes below the 200-day moving average.

Using this set of two simple instructions, it is easy to write a computer program that will automatically monitor the stock price (and the moving average indicators) and place the buy and sell orders when the defined conditions are met. The trader no longer needs to keep watch for live prices and graphs, or put in the orders manually. The algorithmic trading system automatically do it for him, by correctly identifying the trading opportunity.

Algo-trading provides the following benefits:

1. Trades executed at the best possible prices.
2. Instant and accurate trade order placement (thereby high chances of execution at desired levels).

3. Trades timed correctly and instantly, to avoid significant price changes
4. Reduced transaction costs (see the implementation shortfall example below)
5. Simultaneous automated checks on multiple market conditions
6. Reduced risk of manual errors in placing the trades
7. Can be back tested, on available historical and real-time data, to see if it is a viable trading strategy
8. Reduced possibility of mistakes by human traders based on emotional and psychological factors

The greatest portion of today's algo-trading is high frequency trading (HFT), which attempts to capitalize on placing a large number of orders at very high speeds across multiple markets and multiple decision parameters, based on pre-programmed instructions.

Algo-trading is used in many forms of trading and investment activities, including:

1. Mid-to long-term investors or buy-side firms—pension funds, mutual funds, insurance companies—use it to purchase stocks in large quantities when they do not want to influence stock prices with discrete, large-volume investments.
2. Short-term traders and sell-side participants—market makers (such as brokerage houses), speculators and arbitrageurs–benefit from automated trade execution; in addition, algo-trading aids in creating sufficient liquidity for sellers in the market.
3. Systematic traders—trend followers, hedge funds or pairs traders (a market-neutral trading strategy that matches a long position with a short position in a pair of highly correlated instruments such as two stocks, exchange-traded funds (ETFs) or currencies) etc.–find it much more efficient to program their trading rules and let the program trade automatically.

Algorithmic trading provides a more systematic approach to active trading than methods based on a human trader's intuition or instinct.

The NSE is facing allegations that some brokers got preferential access to the trading system through the co-location facility (where brokers can buy "rack space" for their servers) at the stock exchange, early login and "dark fibre", which can allow a trader split-second faster access to the data feed of the exchange. Even this split-second faster access is considered capable of bringing huge gains to a trader.

8.17 Shell Companies

A shell company is described as a non-trading organisation that does not engage in any activity but exists only as medium for another organisation's business activity. Shell companies are usually listed on a stock exchange and are not illegal inherently; however a large number of them are used as a vehicle for illegal activities like tax avoidance or for trying to cover up a trail of money. These companies exist only on paper and have no physical presence.

How does a Shell Company Function?

Illegal activities generally carried out by a shell company include tax evasion, bankruptcy frauds, fake services schemes, market manipulation and money laundering.

One of the aims of a shell company is to turn the illegally held money into legal wealth for which tax has been paid and the source is accounted for. These companies are typically created by the person(s) that hold(s) the unaccounted money. Once these companies are formed the shares are sold at high premium to other businessmen or investors who are aware of the true reason behind the formation of such companies. The buyers or investors are given coveted deals (coal, land, petrol etc) as a reward.

Often companies that want to hide their actual profits buy and sell through shell companies which are based in one of the tax havens. Transacting through these shell companies ensures that the initiating company does not have to report its transactions (due to the country's tax laws) and hence is successful in avoiding taxes.

Generally infrastructure companies are the most active in this area as these companies are required to bribe a large number of people ranging from politicians to government officials to local mafia. The infrastructure company would pay the shell company X amount through a cheque which would later be returned by the shell company in cash. This cash is then used to pay the bribe. The shell company covers its tracts by showing it as a payment to other smaller shell companies.

Shell companies that are created without a business or a listing are known as shelf companies. These companies are then bought by another company which may have some legitimate business but may not want to spend time, money and effort that goes in creating a company. This may be one of the not so illegitimate uses of a shell company. Some of the other legitimate uses of such companies is parking asserts while dealing in complex transactions, protecting trade secrets and as a tool in mergers.

8.18 Explanation to Section 73 and Derivative Transactions and Brokerage Income

i. Prior to the insertion of Clause (d) in proviso to sub Section 5 of Section 43, revenue has been holding that the transactions in derivatives were speculative in nature. ITAT in several decisions have held that even before the amendment of Section 43(5) these transactions were non speculative in nature. But the Bombay high court in its decision in the case of 199 TAXMAN 87 (Bom.), *Bharat R. Ruia (HUF),* has held that exchange traded derivative transactions carried on by assessee before 24/01/2006 were speculative transactions covered under Section 43(5) and loss incurred in those transactions was liable to be treated as a speculative loss and not as a business loss.

ii. Prior to this amendment, department has been allowing the set off of the loss in share trading deemed to be speculative loss as per explanation to Section 73 against the profit in the derivative trading. After 24/01/2006, this is to be disallowed.

iii. Further, it is also to be kept in mind that along with the insertion of Clause (d) to Section 43(5), an explanation has also been inserted, which defines the term "Eligible transaction used in Clause (d)". As per this explanation, only certain type of transactions in trading in derivatives carried on by recognized stock exchanges are eligible for being treated as non speculative transactions. The notification under this Section No. S.O. 89(e) dated 25/01/2006 with effect from the same date recognizes Bombay Stock Exchange and National Stock Exchange for this purpose. Thus, the transactions in trading of derivatives carried on by following the conditions mentioned in the explanation to Section 43 (5) after this date on BSE and NSE only can be treated as non speculative transaction.

iv. The brokerage income of the share brokers are not to be adjusted against the loss in share trading deemed to be speculative loss as per explanation to Section 73, till AY 2014–15, as per ratio of the following decisions:

   a. 74 ITR 754 (SC) *Pangal Vittal Nayak and Co. P. Ltd:*

   b. *Frontline Capital Services Ltd.* 96 TTJ (Del) 201:

From AY 2015–16, if a corporate assessee is trading in shares, then explanation will not be applicable. But still non delivery based transactions will be speculative.

Treatment of Derivative Losses

i. As per stand taken by the department in the past, such transaction are speculative in nature till 25/01/2006 and after that day, these are non speculative if carried out on NSE or BSE. Transactions on other exchanges are still speculative. Also as per Section 18A of the SCRA 1956, a derivative contract can be legal and valid in following circumstances only:

"SECTION 18A:

(Contracts in derivative

18A. Notwithstanding anything contained in any other law for the time being in force,

contracts in derivative shall be legal and valid if such contracts are—

a. *Traded on a recognised stock exchange;*

b. *Settled on the clearing house of the recognised stock exchange,*

in accordance with the rules and bye-laws of such stock exchange.)"

ii. Thus bogus losses created on account of derivative transactions can be detected by investigating as to whether these have been done on recognized stock exchange or not.

iii. The AOs should invariably, in case of loss in derivatives, call for the details and contracts of the broker. From the contracts, the genuineness should be examined by checking with the Exchange where the transactions have been executed.

8.19 Tax Rate on Derivative Transactions/ Capital Gain from Debt or Liquid Funds etc

As per Section 111A, only the short term capital gain from transactions in equity shares or units of equity oriented mutual funds and which have suffered STT can be taxed at 15% rate. Accordingly, the gain arising from non equity oriented schemes of mutual funds like debt funds, liquid funds, gold exchange traded funds etc is also not eligible for concessional rates of taxes in case of STCG and exemption from taxation in case of LTCG, but is to be taxed at full rates. Nature of the fund can be determined by finding out whether STT has been charged on sale and purchase. STT is leviable only in the case of Equity oriented funds.

8.20 Provision of Losses on Unrealized Future Contracts/ Interest Rate Swaps/ Repo Transactions to be Disallowed

Assesses should be asked to furnish the details of provision made for notional loss on account of open contracts in derivatives and Interest Rate swap (IRS) on the last day of the financial year and debited in the *P&L* account. Such losses being contingent losses are to be disallowed. Generally assessees are only accounting for losses on MTM and profits are being ignored. Hence the decision of the SC in the case of Woodward Governor and of Mumbai ITAT in the case of *Bank of Bahrain & Kuwait* (41 SOT 290 (Mum)) (SB) are not applicable.

8.21 Conversion of Stock in Trade into Investment

The Act was silent on this issue till the new provision was introduced by Finance Act 2018. The most important aspect of this issue is the analysis of the nature of transactions done by the assessee after the alleged conversion. The AO should find out whether after the alleged

conversion, the assessees transactions are in the nature of an investor, or he continues to act as a trader only. This fact should be clearly brought on record. Till the issue is settled by the Act, case to case basis analysis will have to be made to determine the allowability of such conversion. This should be done in the year of conversion itself. Refer clauses 12 and 12A of Form No 3CD attached to the Tax audit report which give such details.

In the judgment in the case of *Wallfort Financial Services Ltd. vs. Additional Commissioner of Income-tax,* Range 4(2), Mumbai, reported in (2010) 41 SOT 200 (MUM.), the ITAT has analyzed this issue in detail. In this case, the assessee, a share broker, tried to pass off his trading transactions in shares after 01/10/2004 as investment in order to take advantage of the lower tax rate. After analyzing all the facts, the ITAT has decided the issue in the favor of Revenue. Again it should be noted that in this assessment order, all the facts had been well marshaled and fully analyzed.

Besides in (2015) 63 taxmann.com 263 (Delhi), *Abhinandan Investment Ltd*., it has been held that where stock in trade is converted into capital asset, the holding period for the purposes of classifying it as long-term or short-term capital asset shall be reckoned excluding the period for which it was held as stock-in-trade prior to conversion.

8.22 Disallowance under Section 14A

1. The disallowance to be made under Section 14A has to be examined as per rule 8D. Go through Bombay High Court's decision in Godrej & Boyce and Mumbai Special Bench decision in the case of Daga Capital Management Pvt. Ltd. in this regard. As per the decision of Bombay High Court in the case of Godrej & Boyce, Rule 8D will be applicable from assessment of AY 2008–09 only.
2. In assessment years prior to this, the AO has to disallow a reasonable amount and also while computing the disallowance, the shares held as investment and stock in trade both should be considered.
3. Also reasons for not being satisfied with the correctness of the claim of expenditure of the assessee or his claim that no expenditure has been incurred in relation to exempted income must be given in the order for the order to stand the test of judicial scrutiny. During the assessment proceedings, the assessee should be asked to furnish details of the sources of investment, including stock in trade, in the shares and securities or any other instrument from which exempt income was earned. He should also be asked to furnish details of the persons/ staff involved in handling such activities. After considering all these facts, a clear finding should be given in the assessment order for the purposes of applicability of Section 14A.

In the recent case of ***MaxOpp Investment vs. CIT,*** **Hon'ble SC** held as under:

> "*S. 14A/ Rule 8D-Applicability to shares held for controlling interest or as stock-in-trade: The argument that Section 14A & Rule 8D will not apply if the "dominant intention" of the assessee was not to earn dividends but to gain control of the company or to hold as stock-in-trade is not acceptable. Section 14A applies irrespective of whether the shares are held to gain control or as stock-in-trade. However, where the shares are held as stock-in-trade, the expenditure incurred for earning business profits will have to be apportioned and allowed as a deduction. Only that expenditure which is "in relation to" earning dividends can be disallowed under Section 14A & Rule 8D. The AO has to record proper satisfaction on why the claim of the assessee as to the quantum of suomoto disallowance is not correct*"

8.23 Investigations in Bogus Long Term Capital Gain/ Short Term Capital Gain Cases

i. There are several entry providers who are engaged in providing the entry for bogus short term/ long term capital gain. The modus operandi followed by them is as follows:

a. **Short Term Capital Gain/ Loss:** The entry providers prepare a list of scrips having sizeable price difference over a period of time. When a client approaches the entry provider for bogus delivery profit, they would feed bogus '*saudas*' in the software used for recording share transactions by entering bogus dates, time, no. of order, STT, service tax, etc., showing purchase and sale of scrips. These transactions are not done through the stock exchange but the bills show them to be so and appear to be genuine transactions done through the stock exchanges. The client gives cash against these profit bills. The cash is deposited in some third account and then the funds are transferred to the bank account of the concern of the entry provider issuing the bill. The cheque equivalent to the amount of profit is issued to the client from the account of the broking concern, thus enabling the client to generate short term profit. In many cases no actual delivery of shares takes place. However, some clients insist on delivery of the share to give a real colour to this transaction. In such cases, the entry provider transfers them shares from its demat account off market as the purchases are back dated for giving this entry and takes them back in a few days off market or through stock exchange. In case of loss, cheque is received from clients and cash is returned to them.

b. **Long Term Capital Gain (LTCG):** In such cases a back dated purchase bill is issued to the clients. Against such purchase bills, if the client has cash in hand, on the alleged date of purchase, it is shown to have been received on that day but *if not*, a back-dated Speculation profit Bill is given of a similar amount so that the purchase can be shown to have been made out of such profit. But obviously no actual delivery of shares takes place on the date of purchase because the entire purchases are fraudulently shown to have taken place on an earlier date. The minor balance, if any, lying in the ledger account is transferred to the 'discount' account. The shares are transferred to the demat account of the client (off market) generally around a few days before the date when the client wishes to avail the gain. Many clients ask for what are known as 'holding letters'-which are basically letters issued from the entry providers that they have purchased '*x*' amount of shares on behalf of such clients on a particular date (the back date on which the purchase is allegedly shown) and these companies are holding them in their *pool account* on behalf of these clients. This letter is usually produced before various authorities to prove that the alleged purchase of shares has taken place over a year ago. All these actions are in violation of the provisions of the Securities Contract (Regulations) Act 1956 and hence are illegal.

The client then does one of two things- either he sells the shares in the open market (through BOLT i.e. through his stock broker) and avails LTCG or STCG. In such cases also, if the shares involved are prominent shares, the sale *actually takes place* in the open market.

But if these are shares of some penny-stock companies then the shares are purchased by the group concerns of the entry providers through BOLT available in their offices. In the other type of cases, the client/ beneficiary transfers these shares to the group concerns of entry providers through off-market transactions. Such off-market receiving back of shares is known as *'Touch and Go'* transactions. The alleged broking companies issue sale bills to the client. However, the bills provided by the 'broking' companies reflect the transaction as having been done on market. Thus in *Touch and Go* cases both sides of the transaction are bogus.

c. **Commodity Bills:** The modus operandi is similar to that of issue of speculation profit bills mentioned above.

d. **Derivative Profits/ Loss:** These are similar in nature to issue of speculation profit. Since loss on account of derivative transactions is not speculative, hence it can be set-off against any income. So the alleged broking companies run by entry providers have given a huge number of entries for such losses.

ii. These bogus transactions can be detected by following steps:

a. Obtain the complete details of share transactions including the date of purchase and sale, the broker through whom the sale/ purchase were made, contract notes, details of payments made and received and copies of demat accounts of the relevant period. Check the name of the broker through whom the assessee normally does business and the name of the broker from whom such loss is 'purchased' will be different which will give a clue to do further investigation into the transactions of such broker.

b. Verify the demat statement to ascertain the period of holding. If it is less than one year in case of LTCG or less than the period shown for STCG, it is indicative of bogus transactions.

c. Verify whether the contract note is in the name of the share broker registered with a stock exchange or not. It is very important to note here that as per the circular no SEBI/ MRD/ DOPS/ CIR-11/2005 May 12, 2005, the SEBI (Stock Brokers and Sub brokers) (Amendment) Regulations, 2003, has been made applicable from 01/04/2005. Hence, after this date, as per Clause 2 of the PART B of the code of conduct for share brokers given in Schedule II of the SEBI (Stock Brokers and Sub brokers) Regulations, 1992, only a share broker can issue contract notes to the clients of a sub broker. So any contract note issued by a sub broker will itself indicate that the transactions are bogus as no Sub broker is allowed to issue a contract note.

d. If the contract note is in the name of a share broker, then verify the genuineness of the share broker. A list of all brokers/ sub-brokers is available on the web site of BSE/ NSE.

e. Examine the transactions as per the provisions of the Securities Contract (Regulations) Act 1956.

i. As per Section 13 of this Act, The Central Government is empowered, to apply the said Section by a notification in the Official Gazette, and, upon such declaration, every contract in securities in the State or area which is entered into after the date of such notification, otherwise than between members of a recognised stock exchange, in such State or area or through or with such member, is rendered illegal. Such notification for Greater Mumbai was issued way back in 1957.

ii. The exception to this is the spot delivery contract, i.e. a contract which provides for the actual delivery of securities and the payment of a price there for either on the same day as the date of the contract or on the next day.

iii. Similarly, as per Section 18A, contracts in derivative shall be legal and valid if such contracts are

a. Traded on a recognized stock exchange;

b. Settled on the clearing house of the recognized stock exchange, in accordance with the rules and bye-laws of such stock exchange.

iv. Section 16 of the SCRA provides that:

"16(1) if the Central Government is of the opinion that it is necessary to prevent undesirable speculation in specified securities in any state or area, it may by notification in the official gazette declare that no person in the state or area specified in the notification shall, save with the permission of the Central Government (or SEBI/ RBI), enter into any contract for the sale or purchase of any security specified in the notification except to the extent and in the manner, if any, specified therein.

(2) All contracts in contravention of the provisions of Sub-section (1) entered into after the date of notification issued there under shall be illegal.

v. In accordance with the above, a Notification No. SO 184(E) was published in the Gazette of India on March 01, 2000 stating that no person in the territory to which the said Act extends, shall, save with the permission of the Board (SEBI here as all powers under Section 13 and 16 of SCRA have been delegated to SEBI), enter into any contract for sale or purchase of securities other than such spot delivery contract or contract for cash or hand delivery or special delivery or contract in derivatives as is permissible under the said Act or the Securities and Exchange Board of India, Act, 1992 and the Rules and Regulations made under such Acts and Rules, Regulations and Bye-laws of a recognized Stock Exchange.

vi. Thus outside stock exchanges, only spot delivery contract or contract for cash or hand delivery or special delivery or contract in derivatives as is permissible under the said Act or the Securities and Exchange Board of India Act can be entered. Hence all the back dated share purchases in which the deliveries have not been given within 48 hours of the purchase are illegal and hence do not confer any right on the purchaser. Hence he cannot claim to have held the shares for more than 1 year to claim LTCG.

f. Verify the purchase transaction and payments made for this. If the purchase is on payment of cash or in lieu of speculation profit, then it requires thorough investigation.

g. If either the purchase or sale involves off market transactions, then it requires a thorough investigation.

h. The demat account of entry providers should also be obtained and examined. On the alleged date of sale of shares, in almost all cases no shares would be available in these demat accounts. The entry providers obtain these shares few days before the transfer to the beneficiary either through market if some freely marketable shares like MMTC are involved or by taking loans off market from persons controlling penny stocks. But in all cases, these shares are transferred to the demat account of the beneficiaries through off market transactions.

i. Another important fact is that if on verification any transaction is not found recorded on NSE or BSE, then this transaction must have been made through some person who is not a member of stock exchange.

9. SOURCES OF INFORMATION

The stock exchange is a good source of information for collecting the information about the turnover of the broker. The exchange can provide this information scrip wise, counter party wise, settlement wise, etc… The exchange can also give the list of defaults committed by the broker and the penalties levied on him and the way the same have been collected. The circulars issued by the stock exchange regularly can also provide a lot of information about a particular broker, scrip or the movement of the market.

In an interesting case, in one of the searches on the premises of an assessee, a disclosure of huge unaccounted income was made. However, when the return was filed, it was set off by a claim of loss in share trading in the later part of the year. A careful scrutiny of the case led to the finding that the assessee had made huge losses in stock market transactions after the search. The broker so identified was issued summons for personal attendance. However, neither the broker appeared nor any data was furnished. The assessee was also non-Co-operative in this regard. Lastly, enquiries were conducted with the stock exchange, wherein it was found that the said broker was under suspension for the last two years and was not at all trading in the exchange. Further, the exchange informed the Department, that as per the bylaws of the exchange, a suspended broker is prohibited from trading in securities and as such all the deals were ab initio void. When confronted with these details, the assessee withdrew the claim and paid up the entire tax liability.

9.1 Role of Sub-Brokers

The role of sub-brokers and rogue brokers in assisting evasion of tax is rather well known. In order to verify whether these entities are registered with SEBI, the contract note or the bill should be seen to examine the Registration number. If they are registered, then any violation of the law detected could be intimated to SEBI for further action. The contract notes and the bills should also be seen to know whether the transaction was routed through the exchange mechanism or not. The exchange routed transactions have the exchange confirmation, client ID and the time of execution of transaction on the contract note. The Assessing Officer should call from the exchange, list of rogue brokers and sub-brokers who have been already identified by the exchange. This list would enable detection of fake bills or false transaction details easier.

9.2 SEBI

The Departmental authorities, particularly those assessing the brokers should be in touch with the SEBI authorities so that any information about the brokers involved could help the department in verifying whether the income from such transactions has been offered or not. The information collected from the SEBI will be current, while the assessment would commence after some time gap, hence the information gathered should be further processed and any loose ends plugged till the assessment of the broker is taken up. The leads about client involvement should be invariably be passed on to the Assessing Officer of the client.

9.3 National Securities Depository Limited (NSDL)

The NSDL system is designed in such a way that a clearing member can give and take delivery in electronic form only if he opens an account called the clearing account with the participant. This account takes care of the settlement and

clearing operations of the member where ever he has to give and take securities in Demat form. The main data of the entity is stored in the system of the depository participant itself.

9.4 Central Securities Depository Limited (CSDL)

Here the main data of the entity is stored in the main server located at the BSE premises. Hence, this system can tabulate and generate any data without having to access the participants Database.

10. INCOME COMPUTATION & DISCLOSURE STANDARDS RELEVANT TO CAPITAL MARKET

This ICDS deals with securities held as stock-in-trade.

'Securities' has the meaning assigned to it in Section 2(h) of the Securities Contract (Regulation) Act, 1956 other than Derivatives referred to in Section 2(h) (1a) of that Clause.

Recognition and Initial Measurement of Securities:

1. A security on acquisition is recognised at actual cost which comprises of its purchase price and includes acquisition charges such as brokerage, fees, tax, duty or cess;
2. In case of a security acquired in exchange for other security/ another asset, the cost of acquisition is the fair value of the security/ asset acquired;
3. In case of cum-interest securities, the accrued interest is deducted from the actual cost of the securities.

Subsequent Measurement of Securities:

1. At the end of the previous year, security which is listed on a recognised stock exchange and quoted with regularity from time-to-time, and which is held as stock-in-trade is valued at actual cost initially recognised or net realisable value at the end of that previous year, whichever is lower;
2. Other securities are valued at actual cost initially recognised;
3. Where the actual cost initially recognised cannot be ascertained by reference to specific identification, the cost of such security is determined on the basis of first-in-first-out method;
4. Comparison of actual cost initially recognised and net realisable value is done category-wise and not for each individual security. For this purpose, securities are classified into the following categories:
   i. Shares.
   ii. Debt securities.
   iii. Convertible securities.
   iv. Securities other than above.

The value of opening stock-in-trade shall be the value of the stock-in-trade as on the close of the immediately preceding previous year.

10.1 Valuation of Closing Stock of Listed Securities

Generally shares held as stock-in-trade are valued scrip wise. Paragraphs 9 and 10 of ICDS VIII provide measurement criteria for computing the closing stock of shares held as stock-in-trade, for listed stock and that are quoted with regularity from time to time. It has been further clarified by CBDT in a circular by way of an illustration as in Table 1.

In pre-ICDS scenario, the above diminution i.e.,70 (1160–1090) is recognised as provision for diminution in value of asset and written off in profit and loss account when the value permanently declines (Table 2).

Table 1: Pre-ICDS

Securities	Category	Cost	NRV	Lower of Cost or NRV
A	Share	100	75	75
B	Share	120	150	120
C	Share	140	120	120
D	Share	200	190	190
Total		560	535	505
E	Debt	150	160	150
F	Debt	105	90	90
G	Debt	125	135	125
H	Debt	220	230	220
		600	615	585
		1160	1150	1090

Table 2: Post-ICDS

Securities	Category	Cost	NRV	ICDS Value
A	Share	100	75	
B	Share	120	150	
C	Share	140	120	
D	Share	200	190	
Total		560	535	535
E	Debt	150	160	
F	Debt	105	90	
G	Debt	125	135	
H	Debt	220	230	
		600	615	600
		1160	1150	1135

As per ICDS closing stock value shall be valued each year at lower of cost or NRV and hence in the above example 1135 will be value of closing stock and amount(diminution) to be recognised in the profit and loss account will be 25 i.e., (1160–1135).

The Income Computation and Disclosure Standards (ICDS) apply to all Income-tax Returns to be filed from the year ending 31 March 2016. Some of its provisions can have significant impact on the tax treatment of certain transactions, while some other provisions create uncertainty as to the correct legal position after introduction of ICDS, since they run contrary to the existing legal position. In particular, the tax treatment for share traders gets significantly impacted, as it is substantially at variance with the normal accounting treatment, which would continue to be followed in the books of account.

10.2 Marked to Market Loss/ Gain

Currently, MTM losses/ gains are treated as an expense/ income for tax purposes, in appropriate cases, based on existing jurisprudence. However, ICDS I states that MTM loss or expected loss shall not be deductible unless it has been

recognized in accordance with any other ICDS. However, no ICDS has been notified as on date for MTM transactions, expect for forward exchange contracts, the exchange fluctuations for some of which are to be recognised year-on-year and some to be recognised on settlement, but as per Accounting Standards such contracts are marked-to market on each balance sheet date. CBDT in its clarification has provided that the principle of MTM loss shall apply mutatis mutandis to MTM gains or expected profit. Hence, MTM gains in respect of forward contracts that are to be recognised on settlement will not be recognised as income as per ICDS and other types of MTM gains (except forward contracts) will not be recognised as income until any ICDS is prescribed in this regard.

The FAQ's further clarifies that ICDS shall not apply to computation of Minimum Alternate Tax (MAT) under Section 115JB of the Act, however ICDS is applicable for Alternate Minimum Tax (AMT) under Section 115JC of the Act, as the same is a computation methodology under regular provisions of the Act. Hence, it appears that MTM transactions (other than certain forward contracts as discussed above) will not be considered for normal provisions of the Act and also for AMT calculation, however will be considered for the purpose of MAT provisions.

11. Case Study

Bogus Purchase of Shares to Reduce Business Profit: Mr. X is a share dealer and during FY 2009–10, he finds at the end of the year that he had earned profit of Rs 60 lakhs. However, he wants to file return for Rs 5 lakhs only and prepares profit and loss account accordingly as under (as in Table 3).

As the manipulation of profit is done after 31st March, it would be mostly through bogus purchase of shares whose value would be much lower than the purchase value thereby creating loss on account of valuation of closing stock. However, he can neither show any acceptance of delivery of shares nor can he make any payments by cheques. Therefore, purchase has to be shown on credit and he is also without any evidence of delivery. The bogus purchases also cannot be through a stock exchange and the shares purchased and claimed to be held as closing stock would not be in the Demat Account.

The investigation in such a case should focus on identifying possible bogus purchases.

The first step would be to ask the assessee to submit details in following format under Section 142(1) of the IT Act. The reason for invoking Section 142(1) is that under this provision, an A.O is legally entitled to ask for information in the format he desires.

i. Scrip wise Details of closing stock of shares: Both quantity and value of Opening stock, Purchases, Sales and Closing Stock.

ii. List of trade creditors with details of purchases made for which payments are due.

iii. Copies of demat transaction statement for the period under consideration.

Let us say, in response to such a query under Section 142(1) Mr X submitted following details about transactions in shares (Value in '000) (as in Table 4).

The next step is to analyse the details and identify all big purchases of shares which have not been sold or only a very small percentage of total purchases is sold. For example, in the aforesaid chart, shares which have been purchased during the year and not sold are (as in Table 5).

Next step is to examine each of the shares with reference to whether the share is well known, whether listed on NSE, BSE or regional stock exchange, whether diminution in the value of the share as on the last day of the year is very high and whether the share is purchased on credit? If a share listed on regional stock exchange on which there is very high diminution in value and is purchased on credit, it is most likely to be a bogus share purchase. The aforesaid chart

Table 3

Opening Stock	Rs. 22,00,000	Sales	Rs. 2,47,10,000
Purchases	Rs. 2,60,00,000	Closing Stock	Rs. 60,00,000
Interest	Rs. 12,00,000		
Other Expenses	Rs. 8,00,000		
Net Profit	Rs. 5,10,000		
	Rs. 3,07,10,000		Rs. 3,07,10,000

Table 4

Share Name	Opening Stock		Purchases		Sales		Closing Stock	
	Qty	Value	Qty	Value	Qty	Value	Qty	Value
RIL	1000	700	3000	2100	2000	1600	2000	1700
TISCO	800	320	30000	9540	28000	15800	2800	1097
GAIl	1000	100	0	0	0	0	1000	100
Infosys	100	100	0	0	100	260	0	0
Petronet	900	18	100000	4620	80000	4800	20900	827
TV Today	1000	82	0	0	0	0	1000	70
Simplex	0	0	1000	300	1000	320	0	0
Arvind Mills	0	0	5000	200	5000	250	0	0
Ballarpur Ind	10000	380	0	0	10000	480	0	0
Mukta Art	0	0	5000	500	0	0	5000	300
Smkay Consultant	0	0	10000	1200	0	0	10000	110
Zircon	0	0	12000	1840	0	0	12000	103
Shyam Tele	1000	100	2000	110	0	0	3000	300
Biocon	5	350	1000	500	1005	1005	0	0
Guest Financial	0	0	20000	2000	0	0	20000	240
Rel Petro	1000	50	20000	1250	0	0	21000	1050

Table 5: Values in Thousands('000)

Share Name	Opening Stock		Purchases		Sales		Closing Stock	
	Qty	Value	Qty	Value	Qty	Value	Qty	Value
Mukta Art	0	0	5000	500	0	0	5000	300
Smkay Consultant	0	0	10000	1200	0	0	10000	110
Zircon	0	0	12000	1840	0	0	12000	103
Guest Financial	0	0	20000	2000	0	0	20000	240
Rel Petro	1000	50	20000	1250	0	0	21000	1050

shows that out of five shares, two of them are well known, i.e., Mukta Arts and Reliance Petro and both are listed companies. Even the closing stocks value of those two shares have reduced only marginally. Therefore, both these shares have to be left out of scrutiny angle. Rest of the three shares have to be taken up for further enquiry & investigation because it is apparent that total devaluation on account of these three shares totals to Rs. 45,87,000 (Table 6).

Table 6: Value in Thousands ('000)

Share Name	Opening Stock		Purchases		Sales		Closing Stock	
	Qty	Value	Qty	Value	Qty	Value	Qty	Value
Smkay Consultant	0	0	10000	1200	0	0	10000	110
Zircon	0	0	12000	1840	0	0	12000	103
Guest Financial	0	0	20000	2000	0	0	20000	240

Once the suspect bogus purchases are identified next step is to obtain evidence that the purchases are bogus. This can be done by analysing demat transaction statement, verifying with the stock exchange and the broker, looking into broker's demat account and examining books of account of the Broker.

i. Analyse demat transaction statement. Demat transaction statement is like a passbook of shares. When the assessee has done any mischief, he is not likely to submit the transaction statement and will always pray for more time. Therefore, in the very first notice under Section 142(1), the demat account number and name with address of the depository participant (DP) with whom he maintains demat account have to be asked and obtained. The details furnished can be utilised after the bogus purchases are identified by sending a letter under Section 133(6) to the DP and obtaining the transaction statement related to the assessee for the financial year. If in the transaction statement of the assesse the shares are found not credited it would be an evidence that the purchases are not genuine or real.

ii. Then, write a letter to the stock exchange as the Stock Exchange is a prime witness to the transaction in shares through the broker. Therefore, a confirmation from stock exchange is very relevant. No person can transact without the Broker filling his/ her PAN in order form, PAN is the single most important data to establish authenticity of the trade. Here is a suggested format of the letter to stock exchange.

"Please confirm that M/ s XYZ broker has purchased shares of …… On……

for his client named ……having PAN…… in settlement number

…… vide Trade No ……

Please also confirm if the transaction was done on delivery basis. If yes, please furnish date, quantity, demat account number in which such delivery was made. In case the broker has made the transaction for any person other than mentioned above, Give name and PAN of that person. You are also requested to give the demat account number along with DP name & address of the aforesaid broker, both for his client A/ c/ pool a/ c and self account.

iii. Letter under Section 133(6) to the broker who issued contract note with the following queries should be sent:

1. Have you purchased shares for …… having address …….. on date …….. If yes, please furnish ledger copies of the assessee for the FY ……
2. Did you purchase shares through stock exchange or through Off market?

3. If shares have been purchased from any person other than stock exchange, give name, address, details of payment, the date of delivery taken in your accounts.
4. When did delivery of shares to assessee and in which demat account?
5. Enclose your Demat Transaction Statement for period under consideration.

Here again, if the broker has done some mischief, he will not answer the notice under Section 133(6) or he may shirk from answering. In that case, summons under Section 131 of the Act should be issued to enforce compliance.

iv. Further demat transaction statements of the broker-personal as well as pool account, related to the impugned shares for the relevant financial year have to be obtained from the Depository. If there are no incoming shares or any credit in brokers account on the claimed date of purchase or even within few days after the date, an additional evidence will be on record that no purchase was made by the broker even off-market. Also if in the broker's demat account there is no balance of impugned share available before the claimed date of purchase, it would mean that the transaction was not executed even off-market.

The enquiries/ investigations should thus conclusively establish that the purchases are bogus and income can be assessed by removing the bogus purchases and the corresponding closing stock from the profit and loss account.

12. Check List for Assessing Officer

Generally, the following data could help the Assessing Officer:

1. Client Master list (an alphabetic directory of the clients)
2. Monthly trial balance.
3. Details of outstanding in clients accounts– for monies or shares, for a period of more than 6 months.
4. Client account confirmation with contra accounts for clients having aggregate dealings above Rs. 10 lakhs.
5. Copies of all bank accounts of the brokers, including the account in which the client money is deposited.
6. Copies of the instructions issued to Depository Participant and the instructions received from the clients related to the depository.
7. Margin account maintained by the exchange as well as the broker.
8. Form 10DB of assessee.
9. Global report of assessee from broker.
10. Contract notes for purchase and sale.

The above details should be perused and analysed chronologically. The brokers and sub-brokers notes should be checked for the SEBI registration numbers, client ID and the exchange confirmation of the trade on the contract note. The bank accounts should also be perused to check frequent transfer of funds between certain accounts and the trail should be particularly investigated if the fund flow is huge and the account is connected to any of the related parties.

The pool account of the broker should be checked to see whether any set of clients or securities are lying in the account for a very long period of time and the client is not bothered to see that the securities are transferred back to his accounts.

13. QUESTIONNAIRE

Please furnish the details as required below (Only Capital Market relevant Questionnaire is covered here. AO can ask issue General Questionnaire as per case):

1. Copy of demat accounts of your company and the Directors. If voluminous, soft copy may be provided.
2. Details of securities pledged in respect of secured loans and for overdraft facilities along with proof in this regard. Please also state where they have been reflected in the Balance Sheet. Also furnish the source of investment along with documentary evidence. If the securities are claimed to be belonging to any other persons, necessary confirmation of the parties should be filed. Also prove identity, genuineness and credit worthiness of such parties.
3. Quantity and value-wise details of opening stock/ inventory and closing stock/ inventory and the method of valuation being followed, in the following **pro-forma (Q.3)**.
4. Are there any transactions recorded in your books, regarding sale and purchase of securities which have been carried outside of the stock exchange and thereafter reported to the stock exchange? If so, furnish details of such transactions. Please also submit complete details of any transaction done other than through demat shares with documentary evidence thereof.
5. Are there any transactions recorded in your books, regarding sale and purchase of securities which have not been reported to the stock exchange? If so, furnish details of such transactions.
6. Details of sub-brokerage paid, if any, during the year. Please also give name, address, PAN, assessment details and amount of sub-brokerage paid during the year in respect of all sub-brokers, justification for brokerage paid and confirmation of parties to whom payment above Rs 1 lakh is made. If any, TDS was deducted, the details thereof.
7. Details of fees paid to SEBI and stock exchanges giving nature and rate of such fees. Also submit the calculation of such fee.
8. Details of loss in share trading adjusted against other/ business income, if any.
9. Opening stock of shares/ securities and their valuation relating to both your trading account and investment account separately, alongwith the details of individual scripts and their reflection in the demat accounts. If bulky, soft copies may be provided.
10. Details of profit and loss on purchase and sale of shares/ securities (own account) in the following **format (Q.10).**
11. Details of purchase and sale of shares/ securities (Client-wise) in the following format pertaining to top twenty **clients (Q.11).**
12. Submit share trading account. If there is loss in share trading activity, why explanation to Section 73 should not be invoked in these transactions, being speculative in nature, which is adjusted against other income? Why proportionate expenses should not be allocated while determining share trading loss?
13. Details of tax-free income earned, if any, along with the applicability and working as per Section 14A.
14. Details of vandha loss/ share objection loss along with reasons for each loss.
15. Copy of brokerage account. File the details of top twenty five clients in the following **format (Q.15)**.

Brokerage paid for cash and derivative segments in the above pro-forma should be furnished separately.

16. Copy of 10 DB form of the Top 20 clients and their Global Reports.
17. Details of margin outstanding for every month, with name of party and amount. Address of top twenty parties in each month.
18. Details of arbitrage transactions and income earned. Who looks after this division and how those persons are remunerated?
19. Do you have any research cell? If yes, please elaborate its activities, expenditure incurred and commission/ income earned.
20. Details of amount disallowable under Section 94(7) of the Income-tax Act, 1961.

Pro-Forma (Q3)

Share Name	Opening Stock		Purchase		Sale		Closing	
	Qnt	Value	Qnt	Value	Qnt	Value	Qnt	Value
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)

Format (Q10)

Name of the Script	Purchase				Sale				Profit/ Loss	Dividend
	No	Date of Purchase	Rate	Amount	No	Date of Sale	Rate	Amount		

Clients (Q11)

Name of the Script	Purchase				Sale				Brokerage Received
	No	Date of Purchase	Rate	Amount	No	Date of Sale	Rate	Amount	

Format (Q15)

Sl No	Broker's Name	Address	Pan	Brokerage	Turnover	Client Details (Name, Address, PAN)
(1)	(2)	(3)	(4)	(5)	(6)	(7)

INDEX

Account,
- Bank, Bogus, 106
- Books of, Verification of, 128, 152
- Borrowers, 24
- Capital, 5, 68
- Current, 81, 108
- — Newly-opened, 108
- Profit & Loss, 36–37
- of Promoters, 98

Accounting,
- for Derivatives, 54
- Entries, Understanding the, 136
- Standard, 15–16, 51, 234
- — and RBI Guidelines, 36
- — of NBFCs, 130
- — Indian, 140, 195
- — Key, 130
- — AS 22 for Taxes, 52
- — Compliance with, 77

Acquisition,
- Cost, 18, 61
- of Fixed Assets, 122

Adjustment,
- to the Effective Interest Rate, 51
- to the Income, 46

Advertisements, 82, 77, 94

Agents,
- Canvassing, 68, 134
- Collecting, Payout to, 92
- Collection, 72, 131
- Commissions, Bogus, 137
- and Depositors, 91
- and Sub-agents, Network of, 227
- Travel, 100

Agreement, 17
- Artworks License, 185
- Finalization of, 18
- Preferential Trade, 227

Algo-trading, 263

All-India Debt and Investment Survey, 1

Amortization, 11
- of Investments, 18
- of Premium, 18, 19, 62

Andhra Pradesh Chit Funds Act 1971, 133

Antiquities (Export Control) Act, 222

Arbitrage, 254
- Operation, 254
- Regulatory, 90

Arms Length Price (ALP), 164

Arrangement,
- Avoidance, 215
- Consortium, with an Indian Entity, 170
- for Demerger, 211
- Financial, 127
- between Indian Companies and Foreign Companies, 206
- Leasing, 118, 145

Assessee,
- Net Margins of, 154
- Non-resident, 42, 170–72, 190
- — Presence of the, 167
- Personal Expenses of, 59

Assessment,
of Non-residents, 158
Records, 125, 155
— of the Assesse, 236
Assets, 184
Acquired, 202
Agricultural, Use of, 113
Attachment of, 95
Block of, 197, 198, 203
Categories of, 23
Cherry Picked, 192
Classification, 47, 77
Current, 14
Deferred Tax, 53
Depreciable, 119, 196
Doubtful, 23, 47
Existence of, 121
Financial, 52, 54, 129, 239
— Offset, of, 53
Fixed, 116
— Funds for, 145
— Register, 153
Hire-purchase, 79
Indian, 206
Individual, 195–96, 219
— and Liabilities, 195
Intangible, 113, 197, 202, 204
— Block of, 204
Involved in Leasing, 145
Itemized Sale of the, 196
Leased, Use of the, 123
and Liabilities, 71, 192–93, 196
— of the Undertaking, 210
Located in India, 206
Non-existent, 123, 150
Non-performing, 26, 38, 130
Purchase, 192, 205
Reconstruction, 130
— Companies, 38
Revaluation of, 59, 199
Sale of, 12, 63
Standard, 23, 47
Sub-standard, 23
Tangible, 78, 113, 168, 197
Total, 129
— of the Company, 78
Transferred under Merger, 258
— and Amalgamation, 258
Types of, 116
of Undertakings, 201
Associated Enterprises (AEs), 152
Auction,
Discount, 71
Dividend, 66
Auditors, Functions and Duties of the, 50
Automatic Exchange of Information (AEOI), 163
Award,
Credits, 52
under Customer Loyalty Programs, 52

Balance Sheet, 24, 50, 87, 132, 134, 136, 257
Method, 52
Banker's Books Evidence Act, 49
banks,
Commercial, 7, 11, 50–51, 83, 100, 113, 224
— Foreign, 224
— Indian, 224
Basic Travel Quota (BTQ), 102
Beneficiary,
Businessman, 6
Individuals, 261
Transfer to the, 269
Benefits,
under Applicable DTAA, 207
Available to the Lessor, 117
Duty, for the Exported Goods, 105
Economic, 119
Employee, 31, 235
Exim, 229
of Exemption under Section 10B of the Act, 236
of Export, 106, 230
— House, 225
— Incentive Scheme, 105
Indexation, 256
of India-Mauritius DTAA, 207
Limitation of, 165
Linked to Retirement, 34
Maximum Tax, 146

Mutual, Companies, 81
of Non-taxability, 209
Beyond Permissible Limits of Law, 149
Retirement, 37
Tax, 116
by Transferee Company, 200
Treaty, 189
under the Value Based Advance License (VABAL), 229
Zero Duty, on Capital Goods, 229
Bill,
Commodity, 268
of Entry, 237
— Forged, 108
of Exchange, 3, 48
— Drawing and Dealing in, 48
Black Money, 8, 105, 107, 228, 230, 259
— and Unscrupulous Companies, 231
— Unaccounted, 107
Board for Financial Supervision, 50
Board Meeting, 71, 184
Board of Directors (BOD), 81, 184
Bombay Stock Exchange (BSE), 242–43, 264
Book
of Account, 5, 8–9, 15–16, 25–26, 50, 55–56, 59, 67, 75–76, 82, 104, 125, 128, 135, 137, 141–42, 144, 154, 175, 195, 212, 234–35, 248, 253, 272
— of Banks, 46
— of Broker, 275
— Liabilities Appearing in the, 210
— Moneylender's, 10
— of Seller, 151
of Amalgamating Company, 204
of Brokers, 258
of Hirer, 147
of Lessee, 119–20
— in Case of Finance Lease, 149
— in Case of Operating Lease, 149
of Lessor, 120, 147
Value, 41, 212–13
— of Assets, 198, 210–11, 213
— of Fixed Assets, 200
— and Valuation, 218
Borrower, 8
Borrowing,
from Commercial Banks, 2, 6
and Discounting Facilities, 6
Broker, 7
for Badla Financing, 253
Clients of a, 250
Pool Account of, 276
Broker,
Closely Related, 260
Dealing of the, 250
and Depositories, 258
Fixed, 261
Pawn, Local, 140
Registered, 260
Rogue, 270
Screen of, 251
Scrip, 252
Share,
— Code of Conduct for, 268
— Genuineness of the, 268
Stock, 257
Unscrupulous, 260
Brokerage,
on Securities, 256
of Share Brokers, 264
BSE, 242, 270
Business,
Activities of the Assessee, 167
Arrangement, 215
of Chit Funds, 75, 133
Connection, 163, 166, 181
— in India, 186
— with Western Countries, 234
of Discounting Drafts, 7
Enterprise, Profits of a Non-resident, 167
of Export Clients, 236
Fair Market Value of, 201
Income, 13, 46, 88, 166, 258
— of a Bank, 13
— of Non-resident Assessee, 171
— of Taxpayer, 186
Principal Place of, 62
Profits, 164, 171
— of Foreign Enterprise, 166
— and Gains of, 34, 200
— of Non-residents, 166

Promotion Expenses, 139
Restructuring, 215
Shipping, Profits and Gains of, 159
of Trading in Shares, 132

Calcutta Stock Exchange, 261
Capacity, Lessee's, 146
Capital,
Adequacy, 77, 249
Asset, 79, 197, 203, 255
— in Equity, 256
Contributions Towards, 96
Expenditure, 15, 59, 87, 98, 199
Expense, 46
Fixed, 80
Formation, 240
Fresh, 86
Funds, 240
Gain, 87, 161, 164–65, 184, 196, 201, 210, 212, 247, 255–56, 258–59, 265
— Exemption, 202
— Long Term, 196, 259, 267
— on Shares, 259
— Short Term, 196, 256, 267
— Tax, 196, 198, 205, 208, 217–18, 255, 259
— Taxability of, 196
Goods, 224–25
— Customs Duty on, 224
— Procurement of, 221
— Second Hand, 225
Management, of the Bank, 54
Market, 239, 242, 271
— for Corporate and Financial Intermediaries, 241
— Definitions and Meaning of, 240
— for Government Securities, 241
— Indian, 240
— Secondary, 241
— Supply in, 240
— Types of, 240
Outlay, 13
Paid-up, 69, 85
— Share, 48, 56, 212–13
Primary Market, 240
Receipt, 40, 147, 233
Recovery, 147
Reduction, 217–18
Venture, Funds, 244
Working, 123, 134, 151
— Amount of, 146
— Needs, 116, 146
Capitalization,
Market, 244, 252
— of BSE, 243, 252
Cash,
Book, 7
Flows, Contractual, 54
Management Services, 11
Unaccounted, 144
CBI, 108
Central Board of Direct Taxes (CBDT), 18, 35, 55, 72–73, 97, 119, 206, 271
Circulars, 232
Central Securities Depository Limited (CSDL), 271
Characteristics,
of Current Assets, 14
of Investment, 14
of Manipulated Penny Stock Investments, 259
Chit,
Agreement, 69, 85, 135
Discount, 97, 133
Fund, 68, 72–73, 76, 80, 93, 89, 132, 134
Subscription, 76
— Account, 67, 134
Chit Funds Act, 85
Chit Funds Act 1982, 83, 85, 134–35
Chit Funds (Karnataka), Rules 1983, 133
Claim,
of Bad Debts, 86
— under Income-tax Act, 36
Bogus, 137
— Expense, 137
— Liability, 70, 138
of Depreciation, 88, 127
of Directors, 71
Classification,
as Debt, 53
of Financial,
— Assets, 54
— Liabilities, 54
of Loan Assets, 130

Client,
Account Confirmation, 276
Broker Relationship, 253
Foreign, 236
Identification, 251
List, Master, 276
Register, 251
Commission, 6, 8, 66–68, 76, 82, 84, 90, 105, 229
Agency, 2
Agents, 170, 261
Agreed, 6
Balance, 30
and Bonus, 67
Canvassing, 71
from Chit Business, 97
in Chit, 66
Daily Collection, 72, 139
Excess, 71
Exchange, 56
Foreman, 70–71, 133, 135–39
— Recognition of, 136
— Suppression, of, 137
Income, 51
Kuri Canvassing, 71
Managing Agency, 78
Overriding, 227
Paid for Canvassing Subscribers, 134
Payouts, 98
for Running the Chit, 135
Taxability of, 75
from Transactions, 260
Unjust, 228
Commodity, 240
Prices, Volatility in, 221
Companies Act 2013, 29–30, 49, 192–93
Companies,
Bogus, 228
Comparable, Net Margins of, 154
Dormant, Shareholders of a, 260
Equitable Ownership in the, 244
Fake, 107
Group, 88
Non-resident, 44–45, 187
Paper, 261
— of Entry Operators, 261
Parent, 231
— Abroad, 231
Penny-stock, 268
Private Limited, 67, 261
Comparable Uncontrolled Price (CUP), 153
Competent Authority, 96
Computation,
of Business Profits, 172
of Capital Gains, 199
Computation of Taxable Income, 234
Concern, Genuineness of the, 128
Construction Industry Research and Information Association (CIRIA), 154
Construction, 79, 177
of Immovable Property, 129
or Installation Projects, 169
PE, 169
Contract,
Cable, 230
with Clearing Agent, 237
with Customer, 238
Derivative, 265, 269
Forward, 31, 273
— Exchange, 273
in Securities, 268
Memo, 230
Note, 250, 252–53, 268, 270, 275
— Generation of, 251
— for Purchase and Sale, 276
Parties to the, 51
Race Promotion, 185
Sales, 237–38
for Services, 119
Spot Delivery, 269
with Supplier, 237
Terms and Conditions of the, 237
Contracting State, 43–44
Control,
over Assets and Operations, 192
Export and Import Trade, 226
Financial Fraud, 92
and Management, 182–83
of NBFCs, 129
Operational, 205
Physical, of the Circuit, 186
of the Promoters, 116, 146
Regulatory, 1
of the Unaccounted Cash, 144

Copyrights, 202
Cost,
Actual, 271
— of Asset, 123, 203
— of Block of Asset, 204
— Comparison of, 271
— of Goodwill, 203
— of Securities, 271
of Acquisition, 59, 196–97, 199, 271
— of the Shares, 198
Amortized, 51–52, 54
on Approximate Basis, 17
of Asset, 113, 116–17, 125, 145, 147, 198
— Capital, 198
— Transferred Capital, 203
Direct, 12, 46, 120
of Financing, 118
of Goods, 127
of Goodwill, 204
High, of Raw Materials, 232
of Improvement, 199
of Inflation, 59
Interest, 56
of Investment, 79–80
Low, of Raw Material, 232
of Machinery, 124
Original, of the Leased Asset, 148
Price, 14, 19
— of the Security, 13
of Production, 122
of Purchase, 16
in Quantitative Terms, 17
Recurring, 242
of Resources, 16
of Shares, 198
of Supply of Goods and Services, 122
Synergies in, 192
Credit Rating, 77, 249
Agencies, 249
Management, 12
Creditor, Capacity of, 47
Credit-worthiness, Genuineness and, 277
Cross-examination, Sustained, 5
Cross-fall Breach Clause, 170
Currency,
Foreign, 45, 99–100, 103–04
— Loan Requirement, 181
— Notes, 101–02, 105

Database,
Central, 97
Centralised Architecture, 242
Information on, 95
Online,
— by Deposit Takers, 95
— for Information, 94
SQL, 137
Dates, Bogus, 267, 229
Debenture,
Carrying a Fixed Interest Rate, 41
Stock, 48
Debt,
Bad, 8, 12, 20, 24, 31–33, 57, 58–60, 73, 130
— Allowance of, 73
— Amount of, 22
— in Books of Account, 131
— Credit Card, 59
— from Credit Card Business, 61
— Debit of, 22
— under Section 36(1)(vii) of the Act, 41
— Suppression of, 137
— Write-off of, 24, 31
— Written-off, 21, 63, 131, 137
Equity Ratio, 146
Raising Capacity, 146
Decision,
Commercial, 184
Judicial, 185
Deduction,
for Bad Debts, 199
under Section, 37, 35
under Section 44C, 43
of Taxes, 190
Delhi Chit Funds Rules 2007, 133
Delivery, 3
Actual,
— of Certificates, 254
— of Securities, 269
— of Shares or Payment by the Client to the Broker, 251
of Bill of Lading, 223
Installation and Schedules, 121
Physical, 253
Schedule of the Asset, 149

of Shares, 252
of Shipping Documents, 222
Slip, 251
Demonetization, 61, 144
Departmental Valuation Officer, 152
Deposit,
of Foreign Currency, 105
Takers, Genuineness of, 95
Depository Participants (DP), 242
Depreciation, 18, 55, 114–15, 121, 127, 146, 154, 203
Account, 147
Accounting, 120
Accumulated, 148
Allowability of, 122
Allowance, 127, 200
Amount of, 147
on Assets, 124, 128, 199, 209
— Acquired under Demerger, 210
— Leased, 62, 148
— Non-existent, 151
Benefits, 122, 124, 150
of Buildings, 204
Claim, 60, 119, 122, 150
— on the Assets, 150, 209–10
Cost, Monthly, 153
Currency, 230
Excess, 152
Excessive, on Imported Capital Goods, 233
Expense, 121
and Finance Cost, 154
on Goods, 127
on Goodwill, 204–05, 211
— Arising in Amalgamation, 201
Higher, 121–22
Incorrect Claim for, 202
on Investment, 18, 59, 61–62
and Lease Rental, 146
Net, 55
Rules, 118
Statutory, 148
Unabsorbed, 53, 200–01, 209–10
Derivatives, Selling, of, 46
Devaluation, Total, 274
Directorate of Revenue Intelligence (DRI), 104, 227
Directors, 71
and Auditors, 77
of Company, 132
— Kuri, 69
Conveyance Allowance to, 72
Dummy, 228
and Employees, 71
Meetings of, 72
Disclosure,
Norms of the Stock Exchanges, 47
Required for Income Taxes, 53
to Stock Exchanges, 47
of Transaction Value, 233
Discount, 68, 73–74, 79, 133
Account, 267
and Bonus, 72
Deductibility of, 74
Fixed, 71, 139
and Foreman Commission, 133
Hundis, 7
to Maturity Value, 245
Maximum, 133
Proportionate Amount of, 18
Discounting, 2, 4, 7–8
Bill, 9
Facilities, 7
Firms, 8
Disinvestment, 242
Display of Exchange Rate Chart, 103
Dividend Distribution Tax (DDT), 216–17
Dividend,
Distribution, 218
Tax on Profits after Merger, 218
Document, 4
Discharged, 6
Fake, 257
False, 107
Filed with SEBI, 246
of Money Changers, 104
Substantial, 222
Supporting, 62
Travel, 108
Documentation, 103
Charges, 124, 154
of Comparable Prices, 153
with Lenders, 181
Principal, 128

Domestic Laws of Contracting States, 163
Double Taxation Avoidance Agreement
(DTAA), 38, 157, 159, 162–64, 169–70, 172, 179, 197
Applicable, 46
Article 5 of, 171
Article 7 of, 46
Article 23(1) of, 44
Benefit of, 207
India-China, 172
India-Mauritius, 207
India-Singapore, 173
India-UK, 179–80, 185
India-USA, 172
Protocol,
— to the India-Germany, 165
— to the India-USA, 165, 177
Provisions of, 205
Relevant Articles of, 44
Duration Test, 168, 170, 175–76

Employee,
Contractual Right of, 161
Stock Options, 39
Energy Saving Devices, 88, 123, 132
Enforcement Directorate (ED), 89, 104–05, 107, 235
CBI and, 92
Enterprise, Non-resident, 164, 169
Entities, Offshore, Based in Dubai, 235
Entry,
in the Client Ledger, 251
Operators, 261
Equity,
Creation of, 228
Foreign, Participation, 226
Index, 244, 257
on Initial Recognition, 53
Instrument, 241
Investment, 54
Liability, 54
Norms, 248
Oriented Funds, 256
Share, 54, 81, 212, 240, 243, 245, 247
— Holders, 249
— Public Offer of, 247
Spot Markets, 251
Valuations, 252
Evidence, Digital, 155
Exchange, 254
Control, 223, 227
— Copy, 223
— Manual, 222
— Regulations, 102
Derivative, Traded, 264
Fluctuations, 273
Foreign, 99–01, 105–06, 221, 226–27, 230
— Accumulated, 226
— Authorised Dealer in, 223
— Demand for, 227
— Earning, 221, 224, 229
— Entitlement, 102, 109
— Illegal Purveyors of, 226
— Illegally Retained, 226
— Inflow, 231
— Leakage of, 228
— Obtained from an Authorized Dealer, 101
— Positive, 226
— Proceeds, 106
— Purchases, 101
— Rates, 245
— Received Abroad, 106
— Release of, 107
— Remittances in, 105
— Transactions, 12, 31, 104
— from Unauthorized Sources, 228
Gold, 256, 265
of Information, 153, 165, 233
for Listed Securities, 251
Membership of, 250
of Property, 178
Rate, Dollar, 244
Release of, under BTQ, 102
of Shares, 192
Stock,
— Interconnected, 250
— Recognized, 259, 264, 269
— Regional, 243, 259, 273
Exemption,
from Capital Gain Tax, 212
— under DTAA, 217

from Customs/ Excise Duty on Capital Goods, 226
Excess, 236
from Income-tax, 106
from Tax, 76
— Sales, 151
on Proceeds,
— Export, 232
— Sales, 233
under Section 10A of the I T Act, 1961, 236
under Section 10B, 237
under Section 10B (7), 236
Specific, 97
Expenditure,
Deferred Revenue, 18
Inflation in, 72, 139
Investment, 16
Involved in the Bogus Lease, 151
Expenses,
Bogus, 235
— Employee, 235
Direct, 43
Interest, Allowability of, 122
Export,
Bogus, 233
of Computer Software, 225
e-Commerce, 221
Genuineness of, 234
Net Foreign Exchange on, 224
Sale Proceeds from the Foreign Client, 237

FEMA, 109
— Violation of Provisions of, 235
FEMA 1999, 50, 99, 206, 234
FEMA 2000, 222
FEMA Act, 104
Foreign Exchange Regulation Act 1973, 105–06, 222
Finance,
Cost, 153
and Investment Companies, 131
Financial Intermediaries, 2
Firms, Bogus, 106
FIU-IND, 232
Foreign Direct Investment (FDI), 221
Forex,
Contracts, 31
Ledger Maintenance, 103
Reliable Rate, 238
Formula One Asset Management, 185

Gold Loan Company,
Multi Branch, 141
Small, 144
Group Credit Risk Management, 43
GST Network (GSTN), 122

Hedging, 254
High Frequency Trading (HFT), 263
Hundi, 6–7

Impermissible Avoidance Agreement (IAA), 216
Import,
Bogus, 106
— Documents, 106
Coal, Overvaluation of, 227
Credits, 229
Documentations, 108
Purchases, 237–38
Income Computation and Disclosure Standards (ICDS), 55, 130, 272
Income,
Accruing from Investment, 84
from Capital Gains, 206
of Non-resident, 158, 162, 169
Taxable, 231
— Future, 53
— in India, 188
— of the Employer Company, 40
Unaccounted, 5, 270
— Generation of, 69, 142
Variable Securities, 245
IND AS, 52, 109
Indian Contract Act, 49
Indian Subsidiary, 231
Indian, Non-resident, 42, 157
Individuals, Non-resident, 160
Inflation,
of Closing Stock, 211
of Expenses, 71, 139
— Travelling, 71, 139

Information, 112
from Abroad, 153
Collected from SEBI, 270
from NCLT, 47
on Deposit Takers, 94, 97
about Offences, 96
about Ownership, 153
about Service Tax, 253
Relating to Tax Evasion, 104
about under-Invoicing of Exports, 230
Vital Sources, 47
Insolvency,
Resolution, 216
— Process, 193
Insurance Documents, 125, 128, 155
Interest,
Expenses, 63
Income on Securities, 13
on Loan, 87
Rate, 12, 141
— Effective, 51
— Instruments, 55
— Lending, 140
— Swaps, 55
on Securities, 13–15
Intermediaries, 248, 251
International Financial Reporting Standards (IFRS), 140
Investment,
Account, 277
Banker, 240
Capital, Recovery of, 148
Companies, 77, 82, 86, 88
in Equities, 212
— of Related Concerns, 212
Foreign, 221
in Group Companies, 86
Initial, 114
in Lease, 120
of the Lessor, 120
Made by the Lessor, 145
Managers, Professional, 249
Minimum, 226
Penny Stock, 259
Portfolio of a Bank, 12
Proposals, 13
Purpose of, 17, 132
Quantum, 97
Rising, 240
as per the Scheme of Demerger, 212
in Shares, 78, 86–88
from a Single Lessee, 147
Schemes, Collective, 89–91, 244
at Time of Acquisition, 13
Transaction, 67
Types of, 92
Unaccounted, in Stock, 235
in Unregulated Deposit Scheme, 94
Investor, 77, 251
Active, 248
and Clearing Members, 242
exit Mechanism for, 249
Low-income, 89
Poor and Gullible, 93
Prospective, 247
Retail, 247
Small, 247
Invoice,
Fake, for Non-existent assets, 150
Genuineness of, 127

Jewellery Stock, Excess, 235
Jurisdictions, Foreign, 63

KYC, 49, 102
Compromise on, 261
Document of NBFC, 61, 144
Norms, 228
Registry, Central, 232

Lease,
Agreement, 111, 114, 118, 127, 145, 153
— Date of, 114
— Financing, 115, 146
Benefits, 113
Bogus, 124
Broker, 113
Contracts, 112
Depreciation, 56
Documents, 127
of Fixed Assets, 145
Management Fees, 148

Rentals, Comparable, 153
by Supplier, 118, 145
Terminal Adjustment, 148
— Account, 148
Ledger, 5
Account, 62, 267
Lender, Premises of the, 6
Lessor, Initial Costs Incurred by, 148
Liquidation,
of the PE, 175
Proceedings, 76, 192
Listing Obligations, 47
Loan, 56
Account, Restructuring of, 39
Agreement, 140–41
— Conditions of, 140
Amount, 70
Collection of, Shortfall in, 131
Commitment, 51
Company, 77, 82
Default, 47
in Disguise, 145
Eligibility, 143
Funds, 122
Gold,
— Companies, 140–44
— Disbursal, 142
— Lending by NBFC, 140
Liability, 4
Market, Long Term, 239
Negotiations, 181
Outstanding, 142
Package, 51
Principal, 142
— Amount of, 58
Raised from the Chit Fund, 73
Sanction Letter, 142
Syndication Fees, 51
Third-party, 117
Loss
Accumulated, 200
Adjustment in the Profit and Account, 257
Bogus, and Bogus LTCG, 260
Carry Forward of, 220
— and Unabsorbed Depreciation, 209, 210
of Foreign Exchange, 104
of Investment, 92
Profits and, Elimination of, 53
in Share Trading, 264, 270
— Details of, 277

Machinery Capacity, 153
Maharashtra Chit Fund Act 1975, 133
Management,
and Control, 183
of Documents, 249
Highest Level of, 184
Place of, 182–83
— Effective, 182–83
of Portfolio, 249
Senior, 184
Top-level, 182
Manipulation,
of Books of Accounts, 233
of Penny Stocks, 259–60
Manufacturing,
Concerns, 123
— Bogus, 124
and Selling the Machinery, 124
and Supply, 122
Market,
Capital, Indian Secondary, 241
Grey, 105
Industrial Securities, 240
Money, Indian, 2
Marketing,
Expenses, 77
Fees, 46
Infrastructure, 224
of the Issue, 248
Multi-level, 90
Method,
Conventional, 261
Merger, 261
Most appropriate, 153
Money
Laundering, 137, 228
— Trade Based, 107
Market Operations, 92
Prize, 70, 138
Unaccounted, 7, 72, 228, 233

Moneylenders Acts, 89
Moneylenders, 2–5, 8–9, 11, 58, 89
Agricultural, 2
Importance of the, 2
Professional, 2
Role of, 89
Unregistered, 9
Mutual Funds, Non-equity, 256

Names, Bogus, 71
National Company Law Tribunal (NCLT), 193, 207
National Securities Depository Limited (NSDL), 270
National Stock Exchange (NSE), 243, 264, 270
Government Security Index, 244
National Stock Exchange for Automated Trading System (NEAT), 251
Natural Justice, Laws of, 94
Non-residents, 161–62
in India, 166
Salaries, 159
Notices, Statutory, 209

OECD, 163, 168, 187
Convention, 43
Online Returns Filing System (ORFS), 50
Open Position, 254
Over the Counter Exchange of India (OTCEI), 243, 250
Overdraft Facilities, 277
Ownership, Beneficial, 115, 206

Partnership Arrangement, 82
Patents,
and Copyrights, 119, 147
and other Rights, 172
Payment,
of Commission, 67
against Documents, 222
of Due Taxes, 208
towards Foreign Exchange, 106
to Non-residents, 189
Service, 59
Payment Regulatory Board, 49
Permanent Establishment (PE), 43, 164, 168–69
Characterization of a, 171
Existence of, in India, 167
Fixed-place, 171
— Concept of, 168
Formation, 167
Non-resident, 167
— company, 169
Penalty, 4, 26
Paid,
— by Banks, 12, 25
— to Reserve Bank of India, 86, 130
Proceedings under Section 271BA of the Act, 237
Penny Stocks, 259, 261
Physical Exchange, 202
Pollution Control Equipment, 88
Portfolio,
Managers, 244, 249
of the Gold Loan, 144
Premium, 40, 111
on Forfeited Kuris, 70, 138
on Sale of Special Import Licenses, 226
Share, Short Receipt of, 40
for Transfer of the Prize Amount, 70, 138
Prevention of Money Laundering Act 2012, 109
Price
Discovery, 247, 249
Rigging, 261
Proceedings, Notices for, 208
Profits, 163
Accumulated, of the Amalgamating Company, 218
Actual, 228
Attributable,
— to other Business Activities, 171
— to the PE in India, 45
Attributed to the PE, 171–72
Bogus, Delivery, 267
Book,
— for Banking Companies, 28
— under Section 115JB, 28
Business, Taxability of, 38
Chargeable to Tax, 199
Derived from Eligible Business, 31, 55, 56
Distributable, 41, 246

Earned by the Assessee-company, 78
Enjoyed by the AE, 153
and Gains, 32, 188
— of Business, 59, 60, 130, 161, 188
— of Business or Profession, 161, 256
Good, 233
Inflated, 231
and Loss Account, 24, 27–28, 33, 50–51, 68, 134, 136, 139, 147–48, 212, 271–72
Net, Published, 47
of Non-resident, 166, 171
— Assessee, 171
— Foreign Enterprise, 171
of Permanent Establishment, 44, 171–72
Real and Statutory, 36
Shifting of, 232
Taxable, 258
Project,
Cost, 246
PE, 170–71
Promoters,
Common, of Both Transferor and Transferee Companies, 216
Enrichment of, 88
of the Group, 88
— Companies, 88
Individual, 216
of the Penny Stock Companies, 260
Protocol, 178
Purchase
Bogus, 229, 273, 276
— of Fixed Assets, 88, 132
— of Shares, 254, 273
— suspect, 275
of Capital Asset, 115, 146
Domestic, 107
of Foreign Currency, 99, 103
Made by US Based Software Companies, 230
from Non-existent entity, 233
from Outside the State, 226
Particulars of, 101
from the Public, 101
and Sales of the Goods, 230
of Securities, 277
of Shares, 87, 132
— Big, 273
RBI Act, 8–9, 77, 83
RBI Act 1934, 129, 140
RBI, 19, 50, 76, 83, 101
Amendments, 79
Audit Reports of, 46
Circular, 19–20
— and Norms, 142
Directions, 36, 39, 77
— Non-observance, of, 104
Guidelines, 12, 14, 16, 18–20, 23, 26, 37, 47, 51–52, 57, 92, 106
— Applicability of, 130
Notification, 47, 49, 63
Registration with, 77, 79
Reconstruction, Proposed Scheme of, 208
Recoveries from Bad Debts, 31, 137
Rediscount Facilities, 2
Refund of the Application Money, 249
Regional Rural Banks, 100
Registers and Documents, 69, 134
Registration Act 1908, 112
Registration, 79, 249
of Bye-laws, 68
of Chit Agreement, 135
Certificate, 125, 155
of Documents, 101
Fees, 196
of Leases of Immovable Property, 112
Regulations, Indian Securities, 90
Reserve Bank of India (RBI), 91
Resident,
of Foreign Country, 165, 207
in India, 42
Indian Citizen, 102
of Mauritius, 206
Restriction,
from RBI, 2, 5
of Trading, 261
Return, 5
Assured to an Investor, 249
on Capital, 121
of Income, 71, 139, 154
— on the Due Dates, 211
on Investment, 92
on Loan, 6
Periodical, 130
Quarterly, 46

Submission, 50
Submitted by Banks, 51
Revaluation,
of Asset, 28
of Fixed Assets, 52
of Investment, 18
Reserve, 28, 52
of Securities, 12, 59, 61, 86, 130
Rights,
Commercial, 185
of Company, 201
of Foreman, 135
Form, 247
Issue, 247
and Liabilities of the Lessor, 112
Mineral, 147
and Obligations, 118, 215
Paddock, 186
Renunciation of, 247
of Taxation, 164, 165
Risk,
of Bad Delivery, 253
and Obligations, 171
and Responsibilities, 167, 170
and Rewards, 115, 120, 147
Royalty, 182
Nature of, 178
Paid by Branch, 46
Paid on Brand, 12, 46
Payment, 158
Receipts, 179
Rule, Force of Attraction, 176

Sale,
Bogus, and Leasebacks, 121
Genuineness of a, 128
of Foreign Currency, 102–03
— Notes, 103, 109
of Foreign Exchange, 102, 108
of Rights Forms, 247
of Specified Assets, 196
Sanchayita Investment Scam, 89
Satisfaction of Duration Test, 185
Saudas, Bogus, 267
Scrutiny, 7, 22, 68
of Account Books, 155
Close, 155
Closer, of Transactions, 258
of Correspondence, 25
Special, 5
of Stock Brokers, 255, 256
of Subscriber's Register, 134
Securities Contract (Regulations) Act 1956, 249, 267–68, 271
SEBI Act, 241
Securities and Exchange Board of India (SEBI), 90–91, 96, 193, 231, 240, 245, 247–48, 269
Circular, 47
Fees Paid to, 277
Information from, 47
Investigation, 91
Registered Merchant Banker, 246
Registration, 250, 253
— Certificate, 256
— Numbers, 276
Turnover Fees, 253
Section 37 of Income-tax Act, 40, 63
Section 44C, 42, 43
Securities, 14
Acquired
— by the Banks, 13
— in Exchange, 271
Backed by the RBI, 240
for Firm Allotment, 248
Fixed Income, 245
Fresh Issue of, 241
Government, 15, 25, 52
— and Bonds, 245
— Markets, 239
Handled by the Custodian, 249
Held,
— by the Banks, 14
— under HTM, 14
Industry, 254
Issued
— by Government, 129
Issuer of, 249
Listed
— for Open Auctions Market, 249
— Shares and, 255

Losses on Dealing with, 52
Market, 249
Marketable, 79
Offered, 8
Permanent, 59
Permitted, 251
Redemption of, 19
Related Functions, 242
Returned, 8
Revaluation of Loss on, 41
Selection of, 17
Traded in this Market, 240
Trust, 85
Types of, 240
Service, 111
Agreements, 180
Centre, 242
Charges, 51, 58, 84, 114, 125
Consultancy, 180
Contract, 145
Corporate Advisory, 248
Cost for, Provided, 146
Customer, 99
Depository, at Affordable Cost, 242
Expert, 180
Exports, 221
Fee, 59
Offshore, 170
PE, 169–71
Provider, 58
Receiver, 182
Specified, 94
Tax, 107
Technical, 180
— Fee for, 158, 165, 179
Settlement,
Accounting Date, 52
of Contract, 257
Cycle and Trading Hours, 251
of Exchange Transactions, 252
of Securities Traded on the Exchanges, 242
Share
Brokers, 256
Capital, 80, 202, 218, 229
— of Company, 40
— and Reserves, 218
Delivery of, 251–52, 267, 273, 276
of Group Companies, 86
Market, 191
of Moneylenders, 2
Opening Stock of, 277
Premium, Receipt of, 40
Scaled-up cost of, 217
Trading Account, 277
Shipping Documents, Receipt of, 222
Software Exports, Bogus, 229–30
Source,
Country, 165, 179
of Funds, 87
of Information, 46, 47
of Investment, 88
for Misinformation, 46
Original, 132
Ultimate,
— of Funds, 132
— of Investment, 132
Speculation, 251, 254
Loss, 257–58
Profit, 268–69
Stamp Duty, 220
Star Trading Houses, 224
Stock Exchange, 47, 108, 239–40, 241–42, 244, 249–50, 259–60, 270, 276
Clearing of the, 242
Directive to, 231
Membe rship, 250
Recognised, 271
Stock Exchange on-line Trading System, 251
Stock Exchange Rules and by-laws, 250
stock-in-trade, 86, 132, 255, 266
Closing, 255
Conversion of, 265
Investment, 266
Stock,
Closing, 211
— of Shares, 258
— of Shares Held as Stock-in-trade, 271
— Undervaluation, 258
Companies, 243
Excess, 235
of Goods, 170
Lending and Borrowing, 242
of Listed Companies, 261

Market, 244
of Mid Cap Companies, 244
Options, 12
Price, 263
— Movement, 47
of Shares, 273
Value, 239
Sub-broker, 250, 256
Super Star Trading Houses, 225
Supply, Offshore, 170
Survey under Section 133A, 150
Syndicate Members, 260

Tamil Nadu Chit Funds Act 1961, 133
Tax
Avoidance, 121, 146, 214–15, 217, 263
— Through Artificial Structures, 214
— Issue of, 207
Benefits of Transactions, 215
Capital Gains,
— Liability, 197, 219
— Nil, 255
Credits, 52
Deferred, 53
— on Revaluation, 52
Determination of, 157
Domestic, 163
Evaders, 258
Evading, Serious Malpractices for, 226
Exemption on Transfer, 212
Foreign, Credit for, 42
Havens, Role of, in Money Laundering, 229
Holiday Benefits, 200
Implications, 125, 191, 197
— Understanding of, 157
Jurisdictions, Multiple, 157, 162
Liability, 149, 192, 194, 236–37
— Computing the, 165
— Deferred, 53
— of the Directors, 72
— Higher, 146
— on Transfer of Assets, 208
at Lower Rates, 189
Nil Deduction of, 189
on Payments to Non-residents, 189
Returns of Stock Brokers, 257
Treaties, 163, 166
— Entered by India, 164
— Purpose of, 165
Treatment, 151
— for Share Traders, 272
Taxation
Double, 41, 122, 166
— Agreement, 42
— Elimination of, 38, 163
— Relief from, 165
Issues, 11
of Non-Residents, 157
of Profits, 43
Rights, 162, 206
— Sharing of, 163
on Transfer of Capital Asset, 197
Taxpayer,
Non-resident, 164, 187
Resident, 173
TDS, 46, 185, 189, 256, 277
Compliance, 63
Provisions, 98
Trade
of the Client, 250
Creditors, 273
Trading, 14
Account, 16, 277
Algorithmic, 263
Business, 94
Circular, 260
Cycle, 252
Day, 251–52
in Derivatives, 264
Efficient and Transparent, 250
in Exchange, 252
Facilities, Electronic, 250
Houses, 224–25
Income, 258
and Investment Activities, 263
Liability, 33–34, 200
Normal Businesses, 166
Online, 239, 250
Period, 252
Procedure, 251
Receipts as Short Term Capital Gains, 255

Ring, 250
Rules and Regulations for, 251
of Securities,14, 18, 241–42, 265
— by Assessee, 87
of Stock, 55, 249
Strategies, 14
— Viable, 263
System, 263
— Electronic, 251
Transaction
Arbitrage, Details of, 278
Bogus, 268
Costs, 51
in Derivatives, 264
in Equity Shares, 265
Genuineness of, 151, 153, 255
— Export/ Import, 233
Off-market, 268
Sham, 6
Speculative, 264
in Trading of Derivatives, 264
Transfer
of Assets, 205, 214
— Capital, 161, 166, 197–98
— under the Demerger Scheme, 212
— Depreciable, 196
— Without Liabilities, 196
— to a Paper Company, 208
of Funds for Trading, 3
Pricing, 152, 231
— Adjustments, 12, 46, 61
— Considerations, 207
— in a Developing Country, 231
— in the Income-tax Act, 231
— issues in Hiring, 152
Transfer Pricing Regulations, 232
Treaty,
Model Tax, of the UN, 163
India-Mauritius Tax, 206
Information Exchange, 233

Valuation, 19, 121
Actuarial, 31
Certificates, 121, 150
of Closing Stock, 19, 211, 273
— of Listed Securities, 271
Engineers, 152
of Equity Shares, 212
of Exported Goods, 233
Instant, of Securities, 241
of Listed Enterprises, 252
Report, 121, 210, 128
— Transportation Documents, 151
Rules Prescribed by Reserve Bank, 55
for Securities, 55
of Stock, 211
Techniques, Fair, 55
Value,
of Assets, 210
— of Block,199
— and Liabilities, 210
Verification, Independent, with Clients, 256

Designed and Printed by: Excel Printing Universe, New Delhi, e-mail: printing@groupexcelindia.com, Mob.: 9899127755